U.S. Department of Housing and Urban Development
Office of Policy Development and Research

Volume II:
Settlement Performance Evaluation

Real Estate Closing Costs

RESPA, Section 14a

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REAL ESTATE CLOSING COSTS

RESPA, Section 14a

Volume II
Settlement Performance Evaluation

October 1980

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by Peat, Marwick, Mitchell & Co.
Washington, D.C.

The contents of this report do not necessarily reflect the views or policies of the Department of Housing and Urban Development or the U.S. Government.

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Part I: THE SETTLEMENT PROCESS: A DESCRIPTIVE OVERVIEW

Part 1 of this study presents an overview of the settlement process and it is divided into six sections:

- Introduction to the Study;
- Brokerage;
- Mortgage Lending;
- Private Mortgage Insurance;
- Title Assurance; and
- Legal and Conveyancing Services.

Each section describes one service in relation to the entire settlement process, specifies the providers of the service, and discusses the overall characteristics of the markets within which the services are sold. Geographic variation in the nature of the services, in how they are provided, and in who provides them is also discussed.

The sections are arranged so that they roughly follow the progression of services needed by home buyers. In finding a home, the home buyer consults a real estate broker, who helps him locate a residence suitable to his needs and desires. Once a house is located, a mortgage is usually necessary. Many of the closing costs which this study analyzed are borne by the consumer because the lender needs assurances that the risk of the mortgage is minimal. One of these costs is private mortgage insurance, which protects the lender against some portion of the loss if a foreclosure occurs on a house with a low down payment.

Title assurance protects both the lender and the buyer in case the title to the property is not absolutely free and clear of encumbrances. There are two basic forms of title assurance, the attorney opinion and title insurance. Often the lender decides who the actual provider of the assurance will be.

The last section describes the provision of settlement and escrow services, as well as the preparation of documents. Often attorneys provide these services. However, because of the simple and routine nature of the work, title insurance companies, brokers, and lenders perform these services in some areas.

A detailed discussion of pricing for these services and of the individual settlement service markets is provided in Part 2.

I. INTRODUCTION TO THE STUDY

The Real Estate Settlement Procedures Act (RESPA) was passed in 1974 and amended in 1975. It was enacted in response to concern on the part of Congress that settlement costs were excessive due to inefficient markets, insufficient consumer information, and anticompetitive behavior on the part of some providers. These perceptions were strengthened by a congressionally mandated study completed in 1972.[1] This study reported such conditions and practices as:

- ineffective state regulation;
- kickbacks, commissions, and referral fees among various members of the industry;
- complex and highly variable settlement practices among regions; and
- consumer charges unrelated to provider cost, such as charges linked to the price of the house.

The original version of RESPA, passed in 1974, attempted to deal with these and other potential issues in the settlement industry through a number of provisions. Most importantly, the Act:

- prohibited certain kickbacks and referral fees;
- required advance disclosure of settlement charges by lenders;
- required the development of a "Special Information Booklet" to be distributed to loan applicants; and
- required a uniform settlement transaction form.

The purpose of these provisions was to eliminate certain practices which were felt to be anticompetitive, such as the use of kickbacks and referral fees, and to substantially increase the availability of information to consumers. Congress felt that increased information would promote consumer shopping, which in turn would stimulate competition among service providers.

Once enacted, the 1974 Act appeared to impose substantial burdens on providers, particularly upon lenders who were affected more than other providers by the advance disclosure requirements. As a result, amendments to the Act were promulgated in the Real Estate Settlement Procedures Act of 1975, now in effect. This revision limited lender responsibility for advance disclosure of settlement costs to the provision of good faith estimates, with ranges allowed rather than specific costs. The Act also required that the person conducting settlement make the Uniform Settlement Statement (HUD-1) available to borrowers at least one day prior to closing.

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[1] HUD/VA Report on Mortgage Settlement Costs, January 1972.

A provision of the original Act that was retained in the amendment requires the Secretary of the Department of Housing and Urban Development (HUD) to report to Congress as to whether further federal legislation regarding settlement procedures is required. Specifically, RESPA requires:

> Section 14.(a) - The Secretary...after such study, investigations, and hearings...as he deems appropriate, shall...report to Congress on whether, in view of the implementation of the provisions of this Act imposing certain requirements and prohibiting certain practices in connection with real estate settlements, there is any necessity for further legislation in this area.
>
> (b) - if the Secretary concludes that there is necessity for further legislation, he shall report to the Congress on the specific practices or problems that should be the subject of such legislation and the corrective measures that need be taken.[1].

It is in fulfillment of this mandate that the present study has been undertaken.

In this chapter, the Introduction to the Study, we present overviews of real estate settlement in the context of RESPA and the methodology we employed in conducting this study. Specifically, we discuss: (1) real estate settlement; (2) the legislative history of RESPA; (3) the purpose and research objectives of the current study; and (4) our methodology.

REAL ESTATE SETTLEMENT

This section discusses the purpose and dimensions of residential real estate settlement and the conditions that prompted the passage of RESPA.

Purpose Of Settlement

"Settlement" refers to the transfer of ownership of real property from seller to buyer. That is, it is the formal process by which ownership of real property passes from seller to buyer. Settlement is commonly perceived as the end of the home buying process, the time when title to the property is conveyed from seller to buyer. For the purposes of this study, we use "settlement" to refer to the sequence of interrelated activities that begins with a consumer's decision to sell or buy a home and ends with the actual transfer of title.

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[1] The Real Estate Settlement Procedures Act of 1974, 12 USC 2601.

We limit ourselves in this study to settlement relating to one-to four-unit residential real estate financed through: (1) a lender federally regulated or insured, or (2) a loan insured, guaranteed, supplemented, or assisted by the U.S. government. That is, we limit ourselves to settlement in the context of RESPA.

While the function of settlement is to effect the transfer of ownership, a major purpose of most settlement services is protection; that is, to protect the lender, seller, and buyer against events or circumstances that may lead to financial loss and to ensure that the actual exchange between buyer and seller is the same as the expected exchange. For example, title search and title insurance are to protect the lender's and buyer's equity in the house and property in the case of unforeseen or undiscovered defects or encumbrances in the title. On the other hand, there are costs associated with settlement, and these costs may be considerable, even relative to the purchase price of the property. This potential conflict leads to three questions:

- What is the trade-off between protection and the cost of protection?
- Are the services that are rendered for settlement appropriate and do they adequately protect the lender, buyer, and seller? and
- Are these services being provided efficiently and at a reasonable cost to the consumer?[1]

RESPA attempts to address these questions by providing more complete and more timely information about settlement procedures and costs to consumers of settlement services and by prohibiting certain noncompetitive practices such as kickbacks and unearned fees.

Better consumer information and restrictions on providers are intended to promote greater competition in the provision of settlement services. It is argued that this, in turn, encourages the provision of necessary services at fair prices. Indeed, the basic purpose of RESPA is described as: "...to enable consumers to understand the home purchase and settlement process better and, where possible, to bring about a reduction in settlement costs."[1]

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[1] Reasonable cost is defined as that which approximates the lowest possible cost of providing the settlement service, including a market rate of return (profit).

RESPA also mandates that further study and research be done to determine the necessity for further congressional action. Section 14(a) requires the Secretary of HUD to report on the implementation of RESPA and the need for future legislation. Section 14(b) states:

> If the Secretary concludes that there is necessity for further legislation, he shall report to the Congress on the specific practices or problems that should be the subject of such legislation and the corrective measures that need to be taken. (12 U.S.C., 2612)

This study reviews the behavior and interaction of both consumers and providers of settlement services. It considers the impact of RESPA on consumer and provider behavior and its effectiveness in terms of encouraging the provision of necessary settlement services at a reasonable cost. Finally, it considers a variety of alternatives to the present RESPA legislation.

Dimensions Of Settlement

This study of settlement in the context of RESPA has involved research and analysis of the many dimensions of the settlement process. We have intentionally defined settlement broadly. A brief discussion of the various settlement dimensions helps to define the scope of this study and to provide a greater understanding of settlement itself.

- Settlement Process refers to the steps and procedures involved in the sale or purchase of a home. These steps range from the seller's placing his/her home for sale and the buyer's seeking a home to the actual settlement or closing at which the transfer of ownership is completed.

- Settlement Providers refer to those who provide settlement services or assist in facilitating the settlement process. The provider studies include:

    - attorneys;

    - brokers;

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[1] Special Information Booklet, U.S. Department of Housing and Urban Development, 1976.

- lenders;

- private mortgage insurers; and

- title insurers.

This is not a complete list of providers. Escrow agents, surveyors, appraisers, termite inspectors, and others are providders as well, though their services have not been examined here.

- Settlement Services are those services rendered by providers to consumers and to other providers to facilitate the exchange and complete the settlement process. For example, brokers often facilitate the settlement process by bringing together potential home buyers and home sellers. Title insurers and/or attorneys help to complete the process by searching titles and issuing title insurance. Some services may be required (often by the lenders to comply with secondary market requirements) or may be optional.

- Settlement Practices are determined by tradition, by legislation, and by other factors, and directly affect the settlement process, services, and the way in which services are paid for and delivered. Settlement practices can vary substantially by location. For example, in the Boston metropolitan area an attorney searches and renders an opinion on title. The purchase of title insurance, per se, is not a common practice in this area. In the Los Angeles and Seattle metropolitan areas, there is no actual meeting of settlement agent, buyer and seller, and other parties at the time of transfer. Rather, an escrow agent (who may be the lender, an attorney, escrow companies, or another provider) collects all settlement documents and fees, and, when all stipulations of the sales contract and settlement are met, the transfer of title takes place.

These various dimensions of settlement all play an important role in defining the nature of the home transaction in a given area. RESPA is but one factor that influences these facets of settlement.

Conditions Prompting A Need For RESPA

The history of settlement and the settlement process in the context of residential real estate is one of continual change and adaptation to both precedent problems and transitory conditions. In January 1972, The Washington Post published a series of articles on real estate settlement practices and costs.[1] Ronald Kessler, a Post reporter, interviewed over 100 attorneys, title companies, lenders, brokers, and developers in his two-month investigation. He documented many cases in which consumers were: (1) paying what appeared to be excessive charges for settlement services; (2) paying for services never rendered; and (3) paying charges that varied widely by region.

Kessler reported widespread use of kickbacks, payoffs, hidden payments, and questionable referral arrangements among settlement service providers. Kessler's sources indicated that between one-quarter and one-third of all title insurance premiums were funneled back to the attorney or lender who referred the title business. Some developers, he learned, made it a condition of sale that the buyer use a particular title insurance company in return for free title work on his developments. And some lenders, he reported, required borrowers to use and pay for the services of attorneys from firms which had a direct financial interest in the lender. These revelations created a furor among consumers, public interest groups, and government.

During the time when these stories were released, HUD was completing its own study of settlement costs in conjunction with the Veterans Administration under the auspices of the Emergency Home Finance Act of 1970. Section 701 of the Act deals with settlement costs, and subsection (a) authorized HUD and VA "to prescribe standards governing the amounts of settlement costs allowable in connection with the financing of FHA/VA housing in any area." Subsection (b) required HUD and VA "to undertake a joint study and make recommendations...with respect to legislative and administrative actions which should be taken to reduce mortgage settlement costs and to standardize these costs for all geographic areas."

HUD and VA submitted their report to Congress early in 1972. Their findings were consistent with Kessler's reports in The Washington Post. Among their findings were:

- The buyer seldom decides who will provide settlement services for him. If there is a choice, he usually depends upon advice of the broker, escrow agent, seller, or settlement attorney. Often the buyer is or believes he is required to deal with a particular source for some or all settlement services.

- Competitive forces in the conveyancing industry manifest themselves in an elaborate system of referral fees, kickbacks, rebates, commissions, and the like as inducements to those firms and individuals who direct the placement of business. These practices are widely employed, rarely accrue to the benefit of the home buyer, and generally increase total settlement costs.

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[1] The Washington Post, January 9, 15, 17, 19, 20, 1972.

- Settlement charges often are based on factors unrelated to the cost of providing the services. The overall level of charges tends to be significantly lower when the charge for a service is not directly related to the sale price of property.

- Minimum or recommended fee schedules by local real estate groups often do not reflect the actual work done and tend to increase settlement costs.

- Most public land record systems need to be improved in order to facilitate title search and eventually reduce title-related and other settlement costs.[1]

The HUD/VA Report contained several recommendations which are reflected in both the original and amended Real Estate Settlement Prodedures Act. These included the use of a single uniform settlement statement, limitations on escrow requirements, prohibition on fees for preparation of disclosure statements, and estimates of probable settlement costs to home buyers. However, one recommendation was most controversial.

> HUD and VA will establish maximum allowable charges for all individual settlement cost items paid by both the buyer and seller, except loan discount payments and costs fixed by State and local statutes, for identifiable housing market areas. Government insurance or guarantee will not be issued in any case in which charges exceed any one of the maximums.[2]

HUD published proposed maximum charges in July 1972. The reactions to these charges is reported as follows.

> Public comment on the proposal was overwhelming. HUD received over 800 comments, more than it previously had received on any other subject. Nearly all of the comments were critical of HUD's effort. Congressional reaction was mixed; the Senate version of the Housing and Urban Development Act of 1972 reaffirmed HUD's role in setting maximum settlement charges for FHA-insured housing and expanded HUD's authority to cover some other federally-related mortgages.
>
> The House Subcommittee on Housing, however, voted to repeal HUD's authority to regulate settlement costs. Faced with

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[1] HUD/VA Report on Mortgage Settlement Costs.

[2] Ibid.

> these conflicting reactions, HUD never made its proposed regulation final.[1]

In summary, the settlement industry in 1972 was characterized by: (1) highly variable settlement practices; (2) wide regional differences in settlement costs; (3) certain noncompetitive practices on the part of providers; and (4) consumer ignorance and the need for more timely information. This, coupled with the publicity and controversy generated by The Washington Post articles, the HUD/VA Report, and HUD's abortive efforts to specify maximum settlement charges, set the stage for new legislation and the passage of RESPA.

THE LEGISLATIVE HISTORY OF RESPA

RESPA was signed into law on December 30, 1974. It was significantly modified in the amended RESPA signed January 2, 1976. The intent of the original RESPA was to ameliorate those conditions uncovered by The Washington Post and the HUD/VA Report of 1972. The 1975 amendments dealt primarily with the repeal or modificaton of: (1) the disclosure requirements of Sections 6 and 7; and (2) the exclusion from the prohibited practices in Section 8 of certain cooperative arrangements between real estate brokers and other settlement service providers.

The Original RESPA

After the controversy over HUD's efforts to set maximum settlement charges, the House and Senate intensified their debate about settlement. Diana Stoppello describes the course of events leading to the original RESPA.

> From 1972 to 1974, Congress considered numerous settlement cost bills, which represented three different approaches to federal settlement cost regulation: (1) HUD regulation of maximum charges for settlement services for all federally-related mortgages; (2) payment by mortgage lenders of all settlement costs attributable to the transfer and financing of the property; and (3) advance disclosure of settlement costs. In 1974, the House and the Senate passed similar advance disclosure bills, although, as in 1972, they differed as to whether or not to repeal HUD's authority to set maximum settlement charges for FHA-insured housing. This question had been the subject of heated floor debate in both houses

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[1] Diana Stoppello, "Federal Regulation of Home Mortgage Settlement Costs: RESPA and Its Alternatives," Minnesota Law Review, Vol. 63, No. 3, March, 1979, p. 377.

of Congress. The House and Senate conferences, after recognizing that HUD was not using its regulatory authority, agreed to continue that authority for its deterrent effect. According to the conferees, nothing in the Act was "intended to preclude the Secretary's use of Section 701 authority at any time he finds it necessary to curb abuses in specific market areas." Once this issue was settled, the other differences were adjusted easily. The advance disclosure legislation compromise agreed to by the conferees was concurred with by both houses, and on December 22, 1974, President Ford signed the Real Estate Settlement Procedures Act of 1974.[1]

The Amended RESPA

The Housing and Development Reporter (HDR) describes what happened to the original RESPA.

> Shortly after RESPA became effective in June 1975, HUD and Congress began receiving complaints from real estate professionals and home buyers.
>
> The main complaints centered around delays caused by RESPA's requirement that lenders provide buyers with the cost of each settlement service at least 12 days prior to closing. Lenders also argued that filling in the forms was costly and time consuming.
>
> Following extensive hearings, the Senate passed a bill suspending key provisions of RESPA for a year. Both the House and Senate, however, later agreed on a bill that repealed the most controversial provisions of the Act and simplified the disclosure procedure.[2]

Specifically, the 12-day advance disclosure was repealed. Lenders are now required to provide home buyers with Good Faith Estimates (GFEs) of settlement charges within three business days of the loan application. Upon the request of the home buyer, the person conducting settlement is required to show the buyer the Uniform Settlement Statement one day prior to closing, to the extent that it is completed.

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[1] Ibid., pp. 377-378.

[2] Housing and Development Reporter. Published by the Bureau of National Affairs, Inc. Washington, D.C., September 6, 1976, p.16.

Section 7, which dealt with the disclosure of the previous selling price of existing real property if not owned by the seller for at least two years, was repealed. Also, within Section 8(c) the following qualifications were added:

> Section 8(c). Nothing in this section shall be construed as prohibiting...payments pursuant to cooperative brokerage arrangements between real estate agents and referral arrangements or agreements between real estate agents and brokers, or...such other payments or classes of payments or other transfer as are specified in regulations prescribed by the Secretary (of HUD)...[1]

In the context of this study, these are the most significant amendments. Other less significant changes were made in the Act. For a complete enumeration of all changes, see Appendix A.

PURPOSE OF STUDY

This section considers the focus of the present study in greater detail. The study itself has two basic goals:

- to evaluate the effectiveness of RESPA in achieving its objectives; and
- to assess the feasibility and desirability of modifications and alternatives to the Act.

Under the first goal, we delineate the overall and general objectives of RESPA, and how the Act is to achieve these objectives. This includes a discussion of how RESPA, in terms of process, should work as well as a brief review of the specific requirements that are supposed to trigger this process.

The second goal involves a consideration of modifying RESPA to improve its effectiveness and an analysis of four broad strategies or policy alternatives to RESPA. These alternatives include:

- unbundling settlement services;
- direct regulation of settlement prices and practices;
- minimal regulatory involvement in settlement markets; and
- packaging settlement services at the most competitive point in the market, i.e., Lender-Pay.

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[1] Real Estate Settlement Procedures Act, 12 U.S.C. 2607.

Evaluate The Effectiveness Of RESPA In Achieving Its Objectives

The primary objectives of RESPA are:

- to eliminate what were considered to be abusive or anticompetitive provider practices;

- to better inform the consumer about settlement service prices and product characteristics; and ultimately

- to lower the cost of settlement services.

The success or effectiveness of RESPA is premised on its ability to develop active price competition in the settlement service markets. It seeks to do this by increasing consumer information regarding settlement service prices and product characteristics, and settlement service providers. In addition, RESPA prohibits kickbacks, referral fees, or an exchange of some "thing of value" for the referral of business from one provider to another. By both increasing relevant consumer information regarding settlement services and prohibiting what were regarded as anticompetitive practices, RESPA was intended to reduce the need for referrals. Its supporters expected it to promote active price competition directed primarily at consumers rather than non-price competition for sources of referral.

In order to evaluate the effectiveness of RESPA, we must ask the following:

- Are RESPA's disclosure requirements, information dissemination and other requirements implemented?

- Do consumers use the available information to educate themselves about settlement?

- Do consumers then use their acquired settlement knowledge to shop for settlement?

- Does the shopping affect the competitiveness of settlement markets and are settlement prices reduced as a result?

An evaluation of the impact of RESPA on the cost, appropriateness, and quality of settlement services requires an in-depth understanding of the economic performace of the settlement servicer markets. This needs to be supplemented by an evaluation of the impact of the regulatory, legal, and other aspects of the institutional environment for settlement services as they can have a strong influence on not only the settlement process and settlement providers, but also on the nature and cost of services provided. This analysis, which comprises much of Volume II of this study, is also useful in developing and evaluating policy alternatives to RESPA, the principal objective in Volume III.

RESPA includes several provisions for promoting its overall and general objectives. Sections 4 and 5 of the Act deal with providing information to consumers; Sections 8, 9, and 10 are concerned with limiting provider relationships and requirements. We give a brief description of these sections and refer the reader to Barron's Federal Regulation of Real Estate if greater detail is desired.

Section 4: Use of a Uniform Settlement Statement[1]

Section 4 requires that the settlement agent (i.e., the person who organizes and conducts closing) complete the Uniform Settlement Statement, often called the HUD-1 form. This form:

> "...itemizes all charges imposed upon the borrower and all charges imposed upon the seller in connection with the settlement and indicates whether any title insurance premium included in such charges covers or insures the lender's interest in the property, the borrower's interest, or both." (12 USC 2603)

The settlement agent is required to allow the borrower to inspect the HUD-1 form one day prior to closing upon the borrower's request to alert him to the type and amount of charges he will be required to pay.

Section 5: Lender Provides the Borrower with a Copy of HUD's Special Information Booklet (SIB) and with Locally-Derived Good Faith Estimates (GFEs) for Settlement Services within Three Business Days of the Loan Application.[2]

Section 5(a) requires the Secretary to prepare and distribute booklets to"...help persons borrowing money to finance the purchase of residential real estate and to better understand the nature and costs of real estate settlement services." The first part of the SIB explains, on a general level, the settlement process, guidelines for shopping for services, and home buyers' rights and obligations. The second part explains the Uniform Settlement Statement and has a glossary of the Statement's terms. Finally, there are sections which deal with:

- comparing lender costs;
- calculating the borrower's transactions;

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[1] Paul Barron. Federal Regulation of Real Estate. 1079 Cumulative Supplement No. 2 Warren, Gorham, & Lamont: Boston, Mass. copyright 1976. pp. 2-32 to 2-44.

[2] Ibid., 2-16 to 2-32.

- reserve accounts; and

- adjustments between buyer and seller.

An appendix to the booklet directs the reader to other relevant literature.

While the booklet does mention settlement practices for particular regions, there is one SIB for the entire United States and thus the settlement process and practices are treated generically.

Section 5(c) stipulates that the lender will include with the SIB "...a good faith estimate (GFE) of the amount or range of charges for specific settlement services the borrower is likely to incur in connection with the settlement as prescribed by the Secretary." These estimates are generated by the lender.

The GFEs, SIB, and the HUD-1 provide the central consumer information for RESPA. Evaluation questions concerning Section 5 include, for example:

- Do borrowers receive the GFEs and SIB in a timely manner?

- Do consumers read the SIB? and

- Do borrowers shop as a result of receiving and reviewing the GFEs and SIB?

Section 8: Eliminate Kickbacks and Unearned Fees[1]

Section 8 attempts to reduce or eliminate reverse competition prohibiting kickbacks and unearned fees. Section 8(a) prohibits, in a RESPA-covered transaction, the giving and accepting of "any fee, kickbacks, or "thing of value" for the referral of business."[2] Section 8(b) prohibits, in a RESPA-covered transaction, the giving and accepting of any portion of a fee or price paid by the buyer of settlement services "other than for services actually performed."[3] The effect of these broad provisions is to prohibit any payment or giving of any thing of value pursuant to an agreement unless the party receiving the payment has actually earned it by giving reasonably equivalent goods or services (but not the services of referral) in return.

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[1] Ibid., pp.2-45 through 2-58.

[2] Ibid., pp. 2-46.

[3] Ibid., pp. 2-46.

Section 8 does not prohibit interrelationships among providers and, in fact, some observers cite RESPA as contributing to the rise of "controlled business" in the settlement services.[1] The amendments to RESPA explicitly allow for payments pertaining to cooperative brokerage arrangements that are not necessarily tied to the services actually performed.

Evaluation questions for Section 8 include:

- Has RESPA reduced kickbacks and unearned fees?
- Has Section 8 altered settlement practices?
- Has Section 8 affected provider relationships including the incidence of "controlled business"?

Section 9: Preclude Seller Selection of Title Company[2]

This section prohibits the seller from requiring the use of a particular title company as a condition for purchasing a property which is financed with a federally-related mortgage loan.

Section 10: Escrow Limitations[3]

Section 10 places certain limitations on the lender's requirements regarding escrow accounts. The Act does not require the lender to make interest payments on the escrow to the borrower. Since an evaluation of Section 10 was not included in the scope of this study, we do not elaborate on this requirement.

Assess The Feasibility Of Modifications And Alternatives To The Act

Section 14(b) of the Act requires the Secretary of HUD to consider modifications and alternatives to RESPA if it is found that RESPA has not been effective. We have grouped possible modifications under four basic approaches.

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[1] The term "controlled business," introduced by the American Land Title Association, refers to the "phenomenon whereby persons who are in a position to influence the selection of a title insurance service provider, typically real estate brokers, mortgage lenders, attorneys, and real estate developers, have a direct or indirect financial stake in that selection." It may also be used to indicate the more narrow financial interest of corporate ownership and may refer to all settlement services, not just title insurance. Controlled business and other tied relationships are discussed in detail in Chapter VII.

[2] Ibid., pp. 2-59 to 2-63.

[3] Ibid., pp. 2-63 to 2-68.

Each one is briefly described here. Volume III of this report describes and analyzes these approaches in detail.

Improve Competition in Individual Settlement Markets (Unbundling Approach)

This approach assumes that within each of the settlement service markets there is potential for active price competition and improved market performance. It stresses:

- increasing consumer information;
- encouraging consumer shopping;
- reducing the need for and practice of referrals;
- preventing or discouraging controlled business, referral fees, high commissions, etc.;
- simplifying and unbundling settlement services; and
- providing for direct consumer access to all settlement services.

It is consistent with the original intent of RESPA, but its proponents may view RESPA as being ineffective, perhaps not going far enough.

Directly Regulate Settlement Prices and Practices

This approach involves the actual setting of prices for defined settlement services and prescribing certain practices which, in turn, would affect the settlement process. Chapters II-VI describe the variations in settlement practices and process in the eight Standard Metropolitan Statistical Areas (SMSAs) that were intensively studied. If it is believed that factors exist which preclude the existence of competitive conditions in settlement service markets and which result in higher than necessary charges, the regulation of prices and the provision of services may be justified.

Any direct regulatory action, especially in today's environment, must be carefully justified and analyzed in terms of the providers' abilities to adapt to such regulations and thereby circumvent or invert the intent of the regulation. For example, Section 8 of RESPA is credited by some industry observers with increasing the incidence of controlled businesses in the settlement industries, an unintended consequence of the legislation. Finally, the potential costs of regulation, including the costs to government to implement the regulations and the increased burdens placed on providers and consumers, need to be examined in relation to the potential benefits.

Establish Minimal Regulatory Involvement in Settlement Markets

This is the "flip side" of the previous approach; it asks if the current regulations and laws are having the desired effect and if they are too costly. The same issues are considered here as in the discussion of direct regulation.

Package Settlement Services at the Most Competitive Point in the Market (Lender-Pay) (Bundling Approach)

This approach runs counter to unbundling services. In essence, the lender would be responsible for providing the consumer with a package or group of settlement services. The consumer could pay for these services through a set fee at closing, through an increase in the lender's interest rate, or through an increase in the principal--the total dollar amount of the loan.

The appeal of lender-pay is that:

- Up-front settlement costs for home buyers could be significantly reduced;
- Home buyers would only shop for a lender (which may be the one provider for which they shop at present);
- Lenders would be repeat buyers of the same services and could negotiate lower prices for the same quality services;
- Lenders would pass some or all of this "savings" to the borrower in order to attract the borrower; and
- The borrower's interest would be better served because the lender has a mutual and compatible interest in these same services.

Of course, many issues and questions suggest that lender-pay may have some serious shortcomings or, at the extreme, may not work.

One should note that these alternative approaches are not mutually exclusive. Brokerage services may be unbundled while lender-pay is used to consolidate many of the remaining settlement services. At the same time, some regulatory requirements may be added while others are eliminated or modified.

METHODOLOGY

Two principal approaches were employed to address the research objectives of the effectiveness of RESPA and the feasibility and advisability of alternatives to the Act. These included a national survey of Uniform Settlement Statements (HUD-1s) and a number of local market studies. In addition, relevant secondary data were collected through personal interviews at the national, state, and local levels with public officials and officers of the pertinent industry organizations. Finally, previous studies were examined, and recognized experts were consulted regarding their assessments of RESPA performance, the performance of the settlement service industries, and proposed intervention strategies. This section presents an overview of these approaches and discusses the analytical and conceptual frameworks which support them.

The National Survey

The national survey was designed to provide a national perspective on settlement costs and practices. It entailed collecting a nationally representative sample of HUD-1s. These statements itemize settlement costs paid by the borrower and the seller and are completed for all one- through four-unit residential real estate transfers by the person conducting settlement. The HUD-1s also indicate the contract sales price, total settlement charges, and other dollar items pertaining to the transfer of residential property.

We sought to achieve a number of specific objectives through the national survey of HUD-1s. These objectives are:

- to gather survey data on settlement costs in order to determine estimates of the average total settlement costs and individual settlement costs for the nation, the 50 states, and 8 selected local markets;
- to establish benchmarks for settlement costs in these areas against which cost data from future studies may be compared;
- to develop a data base that may assist in assessing the effectiveness of RESPA;
- to provide data from which differences in the types and amounts of settlement costs may be uncovered and analyzed; and
- to provide a data base with which specific and relevant hypotheses regarding settlement costs may be tested.

A stratified cluster sample was determined most appropriate for achieving the sampling objectives. The sampling frame consisted of the headquarter offices of all U.S. institutional lenders of the following types:

- savings and loan associations;
- mutual savings banks;
- commercial banks; and
- mortgage companies.

This listing was sorted by state and within each state by lender type. The sorted listings were then stratified by size of lender (large and small) based on loan origination activity. This stratification scheme yielded eight cells for each state. Each lender in a state fell within one of the following cells:

- large savings and loans;
- small savings and loans;
- large mutual savings banks;
- small mutual savings banks;
- large commercial banks;
- small commercial banks;
- large mortgage companies; and
- small mortgage companies.

Exhibit I-1 depicts the stratification scheme for institutional lenders.

EXHIBIT I-1

LENDERS STRATIFICATION SCHEME

Lender Type Lender Size	STATE			
	S & Ls	Mutuals	Commercials	Mortgage Companies
Large (stratum I)				
Small (stratum II)				

Four hundred observations for each state and the eight selected Standard Metropolitan Statistical Areas (SMSAs) were sought as a means of developing reasonably reliable estimates of settlement costs by lender type for each geographic area. Proportional weighting, based on mortgage origination activity, was used to determine the number of observations to be collected for each of the eight categories within each geographic area. This would ensure adequate representativeness of the data collected.

Estimates were developed of the average number of HUD-1s completed in each state per month by each of the eight categories of lenders. Using the sampling thresholds developed under the proportional weighting scheme and a conservative estimate of the reponse rate, the number of lenders within each category to be contacted to produce the desired number of observations was determined. Lenders from each state were selected using systematic random sampling (every nth name) from the listing of lenders for each category. Lenders were asked to submit copies of all HUD-1s they maintained for a specified period of months for the latter part of 1978 through January 1979.

Exhibit I-2 shows the number of observations obtained from each state and the eight SMSAs. In only four states was the sampling threshold not attained: Alabama, Idaho, Iowa, and Nevada. The desired number of observations was not reached in two SMSAs: Boston and St. Louis.

From this set, all HUD-1s which were (1) illegible or (2) did not have a contract sales price were eliminated. From the remaining set, a maximum of 300 observations were selected from each state using the same proportional weighting scheme discussed above and were coded and keypunched. All remaining HUD-1s from the SMSAs were processed. Exhibit I-3 gives the number of observations processed by state and SMSA.

Local Market Studies

Detailed analyses of eight local markets were conducted to provide an in-depth look at the way in which local markets operate in providing settlement services. These studies were geared toward understanding the differences in the process of residential real estate settlement and the practices of settlement providers.

A number of criteria were used in selecting the eight local markets to assure that the full range of representative practices were analyzed. They included settlement-related and demographic criteria. Variations were sought in the following settlement-related criteria:

- predominant form of title proof;
- predominant form of closing agent;
- marketable title laws;

EXHIBIT I-2

NUMBER OF HUD-1s COLLECTED

State	Number of HUD-1s	State	Number of HUD-1s
Alabama	226	Nebraska	791
Alaska	1,228	Nevada	257
Arizona	803	New Hampshire	979
Arkansas	587	New Jersey	1,541
California	2,169	New Mexico	900
Colorado	954	New York	535
Connecticut	1,043	North Carolina	1,156
Delaware	1,002	North Dakota	514
Georgia	580	Ohio	1,302
Florida	1,315	Oklahoma	523
Hawaii	1,127	Oregon	945
Idaho	375	Pennsylvania	2,929
Illinois	1,060	Rhode Island	1,338
Indiana	1,837	South Carolina	548
Iowa	362	South Dakota	777
Kansas	702	Tennessee	858
Kentucky	454	Texas	1,997
Louisiana	610	Utah	745
Maine	583	Vermont	955
Maryland	991	Virginia	511
Massachusetts	876	Washington	1,293
Michigan	1,445	West Virginia	511
Minnesota	1,291	Wyoming	1,067
Mississippi	501	Wisconsin	456
Missouri	1,252	Washington, D.C.	549
Montana	908		
		TOTAL	48,258

SMSA	Number of HUD-1s
Boston, Massachusetts	301
Denver, Colorado	612
District of Columbia	549
Jacksonville, Florida	956
Los Angeles, California	464
St. Louis, Missouri	296
San Antonio, Texas	413
Seattle, Washington	987
TOTAL	4,578

EXHIBIT I-3

NUMBER OF HUD-1s PROCESSED

State	Number of HUD-1s	State	Number of HUD-1s
Alabama	196	Nebraska	291
Alaska	460	Nevada	131
Arizona	280	New Hampshire	311
Arkansas	293	New Jersey	297
California	727	New Mexico	293
Colorado	896	New York	245
Connecticut	292	North Carolina	300
Delaware	298	North Dakota	299
Georgia	206	Ohio	267
Florida	1,168	Oklahoma	150
Hawaii	254	Oregon	233
Idaho	266	Pennsylvania	266
Illinois	271	Rhode Island	299
Indiana	289	South Carolina	292
Iowa	172	South Dakota	296
Kansas	508	Tennessee	293
Kentucky	286	Texas	1,024
Louisiana	235	Utah	270
Maine	289	Vermont	288
Maryland	260	Virginia	293
Massachusetts	576	Washington	1,081
Michigan	214	West Virginia	220
Minnesota	254	Wisconsin	271
Mississippi	106	Wyoming	325
Missouri	414	Washington, D.C.	375
Montana	282		
		TOTAL	15,559

SMSA	Number of HUD-1s
Boston	386
Denver	823
D.C.	375
Jacksonville	875
Los Angeles	454
San Antonio	739
St. Louis	296
Seattle	814
TOTAL	4,762

- existence of Torrens statutes; and
- usury ceiling levels.

The demographic criteria were:

- rate of population growth;
- average annual appreciation for single family homes (1974-76); and
- geography.

The intent was to select markets that displayed a wide diversity of settlement and demographic characteristics and geographic dispersion. The following SMSAs were chosen using the selection criteria:

- Boston, Massachusetts;
- Denver, Colorado;
- District of Columbia;
- Jacksonville, Florida;
- Los Angeles, California;
- St. Louis, Missouri;
- San Antonio, Texas; and
- Seattle, Washington.

These eight sites exhibited the full diversity of settlement and demographic characteristics sought. All types of title proofs and closing agents are represented in the sample. Two have marketable title laws. Three have Torrens statutes. At the time of selection, three sites were rapidly approaching their usury ceilings. In terms of population growth, there are three high growth areas, three negative growth areas, and two stable areas. Appreciation rates are rising rapidly in three sites, rising moderately in three, and rising slowly in two. Finally, the eight sites reflect a diverse geographic mix.

Consumer Interviews

Personal interviews were conducted with recent home buyers and home sellers in each of the sites. The purpose of these interviews was to collect data on consumers' experiences in going through the settlement process and their perceptions of and attitude toward the settlement service providers.

Approximately 120 consumers (80 buyers, 40 sellers) were interviewed in each site using structured survey instruments. Exhibit I-4 indicates the actual number of interviews completed in each site. County recorder office data were used to identify buyers and sellers (grantee/grantor). All consumers interviewed settled between September 1979 and January 1980.

Provider Interviews

Approximately 80 personal interviews were conducted in each site with providers of settlement services. These interviews were distributed as follows:

- lenders (40);
- brokers (10);
- attorneys (15);
- title companies (10) and;
- private mortgage insurance companies (all).

Detailed, structured survey instruments were developed and administered for each provider group. These interviews were intended:

- to provide an understanding of the various functions of the settlement providers and the variability of their functions across sites;
- to provide an understanding of the process of settlement and its variability across sites; and
- to elicit the providers' opinions regarding the effectiveness of RESPA and alternatives to the Act.

Exhibit I-5 specifies the total number of interviews with settlement service providers. The totals may be less than expected, based on the number of interviews per site previously indicated; however, some providers, attorneys for example, simply do not operate in some areas.

EXHIBIT I-4

CONSUMER INTERVIEWS

Site	No. Buyers	No. Sellers	Total
Boston	76	11	87
Denver	80	40	120
D.C.	80	40	120
Jacksonville	87	40	121
Los Angeles	79	38	117
St. Louis	75	14	89
San Antonio	80	24	104
Seattle	85	40	123
TOTALS	634	247	981

EXHIBIT I-5

PROVIDER INTERVIEWS

Provider	No. of Interviews Completed
Lenders	288
Brokers	51
Attorneys	84
Title Companies	72
Mortgages Insurance Companies	14

Secondary Interviews

In addition to the interviews with consumers and providers of settlement services, more than 80 personal interviews were conducted with national, state, and local public officials and officers of the industry organizations. Interviews at the local and state levels were completed in the market sites and in the capital cities of the states in which the market sites are located. These were unstructured, openended, face-to-face interviews designed to collect data on industry practices, provider roles, and settlement procedures. Interviewee perceptions and attitudes regarding the effectiveness of RESPA, certain alternatives to the Act, and government regulation in general were also elicited in these interviews.

Interviews were completed at the state and local levels with officials and officers from the following groups:

- state real estate commissions;
- state boards of realtors;
- local boards of realtors;
- multiple listing services;
- state land title associations;
- state insurance commissions;
- state bar associations;
- local bar associations;
- state banking commissions; and
- state banking associations.

Interviews were conducted with representatives from the following national industry organizations:

- National Association of Realtors;
- American Land Title Association;
- American Bar Association;
- Mortgage Insurance Company Association;
- National Association of Real Estate Sales Agents;
- American Banking Association;
- Mortgage Bankers Association;

- United States League of Savings and Loan Associations; and

- National Association of Mutual Savings Banks.

SUMMARY

The purpose of this study is to evaluate RESPA's effectiveness and in light of this evaluation to consider various modifications and alternatives to the Act itself. RESPA attempts to provide the home buyer and seller with greater and more timely information about settlement. It also attempts to reduce certain abusive practices. It is presumed that increased consumer information leads to more shopping and thus more competitive settlement service markets. The primary means of providing information to the consumer is through the distribution by the lender of HUD's Special Information Booklet and the lender's Good Faith Estimates on settlement prices within three business days of the loan application.

RESPA is based on a microeconomic model of competition and its evaluation requires that an economic analysis of the major settlement service markets be performed. This analysis is also used to assess the feasibility and advisability of the four different approaches for modifying or developing alternatives to RESPA.

II. THE REAL ESTATE BROKERAGE INDUSTRY

The real estate brokerage industry plays an important role in the transfer of real property: the matching of buyers and sellers. While some contend that this function is not part of the settlement process, it is, at a minimum, the initial point on which settlement is based. Before we begin to describe the industry's role and attributes, a few comments must be made.

As part of our study, a comprehensive data collection effort was undertaken. While data collection for many of the industries included in the study proved successful, efforts to collect data about this industry were severely constrained.[1]

Our original research plan required numerous interviews with real estate brokerage practitioners,[2] their local and state boards, local multiple listing services (MLS) and the National Association of Realtors (NAR). The data collection process occurred in the context of a number of local class action suits against realtors and a formal FTC investigation. Regrettably, in this context, the PMM&Co. data collection effort vis-a-vis brokers was handicapped.

The original plan assumed collection of over 400 observations. We obtained only 52 observations (12 of which are flat-fee or discount firms). Upon a careful review of the data obtained through these 52 interviews, we recognized that the data were inadequate for several reasons. The limited number of observations provides no basis to make representative statements about the industry. Further, many of the answers given seemed inaccurate and inappropriate, thus rendering our analysis less useful.

As a consequence of our inability to obtain meaningful data directly from brokers and realtors, we have chosen to rely upon other available data, other data sources, and the limited and qualitative observations developed during our research.

THE SETTLEMENT SERVICE

The brokerage industry performs two major functions in the settlement process:

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[1] See Part 2 for a more detailed discussion of this problem.

[2] In this section, we use the terms "broker," "agent," "salesperson," and "firm" in a generic sense to describe the entities engaged in the real estate listing and sales process.

- matching sellers and buyers of homes; and
- assisting in the post-contract arrangements for settlement.

Exhibit II-1 illustrates the general process and information flow related to these functions. Numerous tasks are subsumed within each category, and the required tasks may vary as a function of agency agreements, market conditions, and type of firm.[1]

Matching Buyers And Sellers

The brokerage firm acts as a matchmaker. By identifying the similar needs of buyers and sellers and by bringing these parties together to conclude a sale, the firm earns its commission.[2] While individual transactions require different levels of activities, most firms do perform certain common tasks. These are:

- contacting potential sellers to offer listing and selling services;
- obtaining listings;
- advertising listings through public media and multiple listing services or other cooperative arrangements among firms;
- contacting buyers;
- showing buyers homes on which the firm has a listing or homes on which other cooperating firms have a listing; and
- selling the house by obtaining a deposit (earnest money) from the buyer and a sales contract ratified by the seller and buyer.

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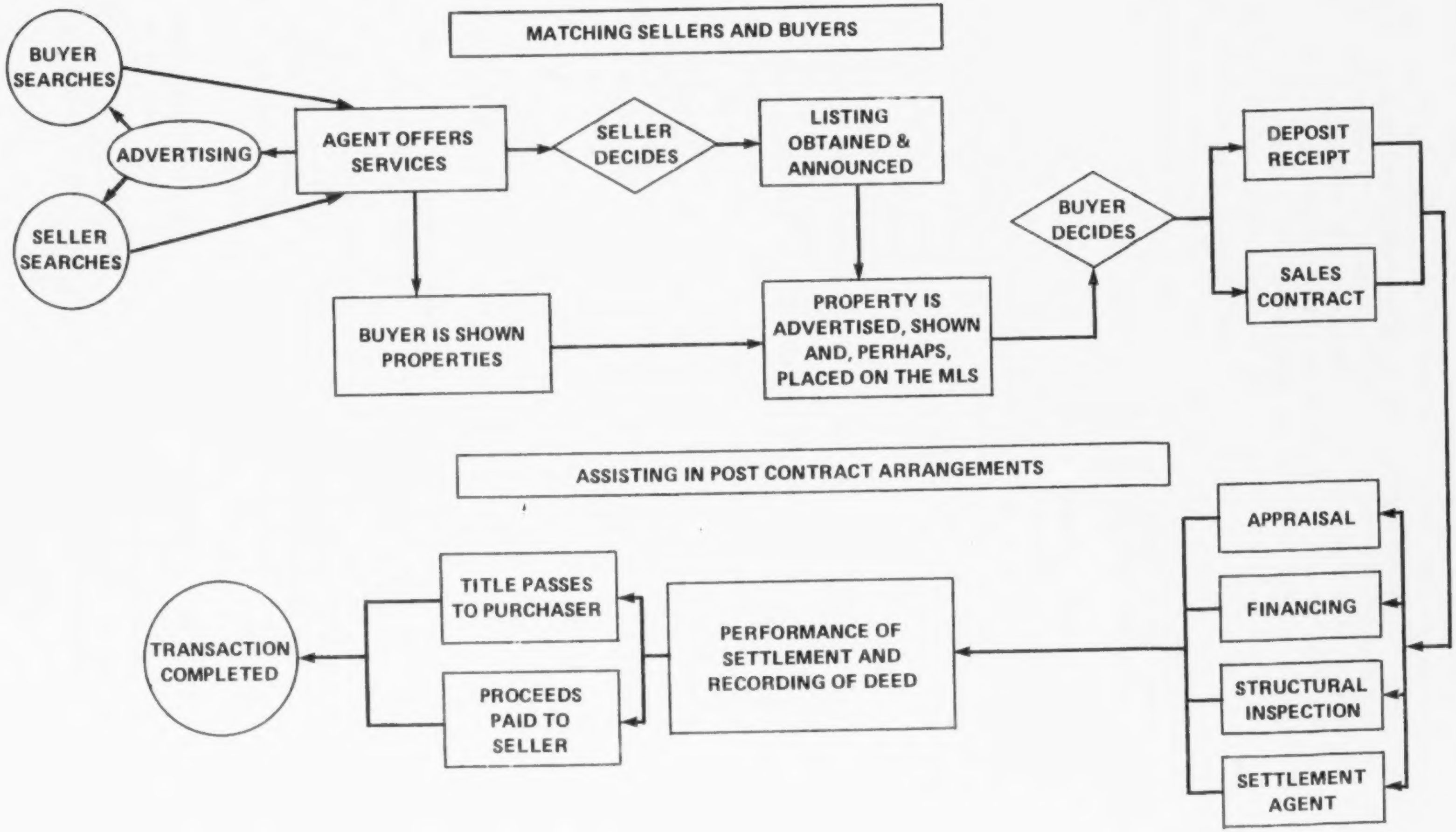
[1] In this discussion, we focus on the activities of the traditional firm. We will explore variation by firm type in a subsequent part of this section.

[2] Technically, the commission is earned when the broker presents a "ready, willing, and able" purchaser to the seller. It is generally paid at settlement or upon disbursement of funds by the settlement agent.

EXHIBIT II-1

GENERAL PROCESS OF THE REAL ESTATE BROKERAGE INDUSTRY


MATCHING SELLERS AND BUYERS
BUYER SEARCHES
ADVERTISING
SELLER SEARCHES
AGENT OFFERS SERVICES
SELLER DECIDES
LISTING OBTAINED & ANNOUNCED
BUYER IS SHOWN PROPERTIES
PROPERTY IS ADVERTISED, SHOWN AND, PERHAPS, PLACED ON THE MLS
BUYER DECIDES
DEPOSIT RECEIPT
SALES CONTRACT
ASSISTING IN POST CONTRACT ARRANGEMENTS
APPRAISAL
FINANCING
STRUCTURAL INSPECTION
SETTLEMENT AGENT
PERFORMANCE OF SETTLEMENT AND RECORDING OF DEED
TITLE PASSES TO PURCHASER
PROCEEDS PAID TO SELLER
TRANSACTION COMPLETED

Firms vary in their approaches to generating business. Typically, larger and more mature firms seek listings which, in essence, become the firm's inventory of homes for sale. While these firms hope to sell their own listings, they will cooperate with other firms to achieve a sale. Firm strategy, however, often will remain focused on the listing process. In contrast, smaller firms often rely on their sales capacity and try to sell the listings obtained by other firms through cooperative agreements. Smaller and younger firms may not be able to obtain listings as easily as their counterparts because they do not usually have a well known reputation, the person-power to create a listing firm, nor the clientele that is developed through years of service in a community.

Listing and selling strategies are also a function of market conditions. In a seller's market, for example, emphasis may be placed on the selling process. Few potential sellers exist in proportion to potential buyers and, therefore, firms concentrate on matching the numerous buyers to the available listings. Similarly, in a buyer's market, there is a greater availability of listings than of buyers, so firms may concentrate on obtaining the best listings.

Finally, the multiple listing service plays an important role in the listing and selling process. A multiple listing service is a mechanism through which participating members share information about available homes for sale. The MLS may be operated directly by a local real estate board, sponsored by a board but operated as a separate nonprofit entity, or may be a private enterprise. Originally, the MLS was operated on a manual basis, and members received weekly updates of available listings. With the advent of the computer, MLSs have become automated, and information has become available almost immediately.

Generally, an MLS member must place a listing on the MLS within 24 hours of receiving it. Also, members agree to "cooperate" on that listing if another firm sells the listed home. That is, the listing firm agrees to split the commission (typically 50/50) with the selling firm.

The MLS essentially provides a catalog of listings for its members. This catalog can be used strategically by the MLS membership. During the listing process, it aides in establishing a listing price as the seller can be shown comparable sales to determine a reasonable price. The listing agent therefore can teach a seller about the market to reduce the seller's demands for an unreasonable price when the seller wants the house sold within a specified time frame. By accurately pricing the listed house, the effort required by the agent to sell the home can be reduced.

The MLS may play a second important role. Because the greatest commission is earned when the listing firm is also the selling firm, it is in the interest of the firm to sell its own listings. However, if a firm places its listing on the MLS, then the listing is available to all MLS members, which reduces the listing firm's opportunity to sell the home.

In theory, MLS members must place a listing on the MLS within a short time of obtaining it. MLS members often are allowed more time to register this listing, which provides the listing firm with an opportunity to make a sale. This may be particularly true when the MLS is a manual system. In such cases, the firm can advertise full MLS services to its clients even though listings may not be available through the MLS books to other firms for several days.

Post-Contractual Arrangements

Once a buyer and seller agree on the terms and conditions of a sale and ratify a contract, the purchaser, assisted by his or her agent, usually must arrange and pay for most items related to satisfying the contract and settlement.[1] The contract might have several contingencies such as a structural inspection or financing contingency. To satisfy the contract, a release of contingencies for a structural inspection and financing must be obtained. The agent may assist the buyer in the purchase of an inspection and can also offer advice and direction on available financing, title insurance, and other settlement services. The seller also may have to fulfill certain requirements, such as obtaining a termite inspection. The seller's agent may provide assistance in this instance.

Once the contingencies are released, the various remaining contract terms must be followed. Often, the buyer has the responsibility to arrange for the actual settlement. Again, the broker or agency may assist in suggesting a settlement agent and in providing guidance during this process. Upon settlement, the purchaser's funds are transferred to the settlement agent and the title deed is provided by the seller. When the settlement agent records the deed and disburses all funds in accordance with contractual terms, the transaction is concluded and, generally, the agent's work is also completed.

TYPES OF BROKERAGE FIRMS

The industry comprises several types of brokerage firms: (1) those that typically charge the prevailing market commission rate and provide a full range of services to list and sell the subject property; and (2) those that charge less than the prevailing market rate and generally provide a reduced set of services. In the latter category are firms that charge a discounted rate and firms that charge a flat fee. These firms are called, respectively, discount firms and flat-fee firms. The data collected as part of this study indicate that nearly all sellers engage traditional real estate brokerage firms to list and sell their homes. Only 6 percent of the sellers interviewed stated that they contracted with a firm that was other than a full service/standard commission firm.

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[1] While the buyer usually pays for these items, this condition is negotiable and variations do occur.

In addition to variations in firm type, variations in types of ownership have emerged as a new and significant issue that may influence the future structure of the industry. Two relatively recent structural changes have occurred in the industry that affect ownership patterns and may, in the long run, modify industry operating characteristics. These are:

- the growth in franchising among traditional and alternative firms; and
- the emergence of national (previously non-real estate) firms as owners of real estate brokerage companies.

Apparently, sophisticated management of large firms has recognized the potential advantages of growing economies of scale as well as the advantages of national referral networks and has begun to capitalize on them by creating nationally linked brokerage operations. In a later part of this section, we will describe the importance of these trends in terms of service delivery. Part 2 describes some of the broader potential implications of these trends for the industry and the consumer.

The two major categories of firms--traditional and alternative (discount and flat fee)--can be differentiated by their pricing, their services, and their employment methods. Each is important in terms of increasing the range of services available to the consumer.

Pricing

Pricing for services rendered is one of the most important characteristics of the industry. It is both a distinguishing feature and a source of conflict among firm types. Because of its complexity, pricing is first examined in general and then placed within the framework of different firm types.

Historical Context

A discussion of pricing requires a review of the historical context within which the industry's pricing structure evolved. This context suggests that uniform pricing was an important industry goal, and, by the late 1930s, achievement of this goal was being promoted by the industries trade association and its members, particularly in California. Industry practice, however, was not without legal challenge.

The California Real Estate Association (CREA) attempted to formally mandate commission rates through the publication of an "official commission schedule" which first appeared in 1941 and was updated annually until 1962. CREA's success is evident in its achievement of a commission rate increase from 4 to 5 percent in 1941. This increase was accomplished through the cooperation of 50 of CREA's affiliated boards, which urged their members to adopt the new rate. Upon witnessing the success of CREA, the National Association of Real Estate Boards (NAREB), the industry trade association, formally mandated minimum fee schedules until the 1960s.

The NAREB-sponsored mandatory fee schedule was dealt its first legal blow in 1950. In the case of U.S. v. NAREB (339 U.S. 485), the Justice Department sued the Washington, D.C., Board of Realtors under Section 3 of the Sherman Antitrust Act, charging that stipulating fee schedules was tantamount to price-fixing. The case eventually reached the Supreme Court which decided in favor of the U.S. and ordered the NAREB to modify the system to one of "recommended" rather than "mandatory" commission rates.

The persuasive acceptance of the uniform commission rate was still in evidence as CREA and the local urban boards in California sought to raise the rate from 5 to 6 percent in 1959. After two years of effort, the State Association Board of Directors formally approved the 6 percent rate, citing as justification the overall decline of net income to realtors between 1950 and 1959.

No further challenges to the now "recommended" commission fee schedule arose until 1971, when the U.S. Justice Department sued NAREB again for price-fixing under provisions of the Sherman Antitrust Act. The Justice Department obtained a consent order prohibiting NAREB's publication of the "recommended" rate schedules. By the early 1970s, then, formal mechanisms maintaining uniform commission rates ceased to exist.

Three Components of Pricing

Gross listed commission rate, actual commission rate, and commission rate split are three aspects of pricing that require further definition.

The gross listed commission rate is that rate advertised and agreed to by the firm and the seller when a property initially is placed on the market. The NAR no longer formally mandates or recommends (listed) commission rate fees; however, there is substantial evidence that current listed commission rates are highly uniform with localities at 6 or 7 percent.[1]

The actual commission rate refers to the commission rate fee actually paid at settlement. The actual price paid by the seller may be lower as a result of negotiation between the seller, the buyer, and the agent or broker.

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[1] For further discussion, see Bruce Owen, Real Estate Brokers, The Pricing Dilemma.

The commission split occurs between: (1) the listing firm and the selling firm, and (2) the firm and its agent participating in the transaction.

The commission split between the firm listing the property and the firm selling the property generally is 50/50. This is particularly true when the transaction takes place on a listing from the multiple listing service.

The commission split between the firm and its agent also may be 50/50, but our small sample of Washington, D.C., brokers demonstrated that this, in fact, is often not the case. The larger and more profitable firms may have complex commission split plans, involving one or more of the following conditions:

- commission split scaled to agent's income or sales revenue;
- commission split based on whether the agent or the agent's firm listed the property, sold it, or both;
- investment opportunities made available to sales agents through a brokerage firm's sponsored residential development; and
- profit sharing programs.

Prevailing Commission Rate Conformity

Literature on the industry strongly indicates the presence of uniform commission rates within metropolitan areas in the United States. A study by Bruce Owen documents commission rates uniformity in three separate data collection efforts in the State of California. Michael Carney sampled 1,108 1975 RESPA (HUD-1) forms from seven market sites in the United States and determined that in various cities examined, high concentrations of actual commission rates were paid at 6 and 7 percent. In Bridgeport, Connecticut, for example, Carney found that 82 percent of the commissions paid were at 6 percent. Similarly, he found that in Denver, Colorado, 83 percent of the commissions paid were at 7 percent. Carney found similar clustering in the samples drawn in five remaining cities.

In our own sample of HUD-1 data, we found similar but not as high concentrations of commissions paid. Whereas Carney reports that 79 percent of the commissions paid in Los Angeles were at 6 percent, we found that 65.5 percent of the commissions were at 6 percent in Los Angeles. Upon further examination of the distribution of commissions paid, however, the concentration at 6 percent receives considerable emphasis because it is the highest category of commission paid; "less than 5 percent," represents only 19.5 percent of the commissions paid. The third highest category, "5 percent," represents only 6.9 percent of the commissions paid.

These data are analyzed more closely in Part 3 of this volume.

Pricing Methods

Pricing methods vary from one type of firm to another. Exhibit II-2 compares traditional and alternative firm pricing methods.

Traditional Firms

Traditional firms generally charge the prevailing rate in the community where they are located. This rate is the gross listed commission rate, generally 6 or 7 percent, and may differ from the actual rate charged upon the sale. Rates also differ by category of property: brokers often charge less when listing newly built homes but charge higher rates (often 10 percent) on undeveloped land. Whereas rates appear uniform on the listing of existing residential properties, rates in other circumstances will often depend upon what the market will bear.

When two firms cooperate on a sale, the commission split between listing firm and selling firm generally is 50/50. This is particularly true of cooperation on an MLS listing, which often stipulates a 50/50 split between firms. However, the listing firm/selling firm split may range from 66 percent to 23 percent for either firm.

The commission split between the firm and its agent is highly variable according to each firm's individual compensation plan. Generally, the larger and more profitable the firm, the more complex and sophisticated will be its agent compensation plan.

Discount Firms

Discount firms, like traditional firms, charge for service via commission rates, which may range from about one percent of the home's sales price to about 2 percent below the prevailing rate.

Co-brokering with a traditional firm charging a higher commission rate presents special problems for the discount firm. If the discount broker lists the home, the traditional broker may only receive 50 percent of the discounted commission. As an incentive to encourage a traditional firm's cooperation, the discount firm may give the traditional broker his customary commission and simply keep the remainder for himself. If the cooperation occurs on a traditional broker's listing, the discount broker often rebates to the seller the dollar difference between the traditional commission fee and the discount commission fee. Traditional brokers find discounters more acceptable than flat-fee brokers; discounters usually belong to both the Board of Realtors and the MLS, while flat-fee brokers often have membership in neither.

EXHIBIT II-2

TRADITIONAL AND ALTERNATIVE PRICING METHODS

TRADITIONAL FIRMS	ALTERNATIVE FIRMS	
	DISCOUNT	FLAT-FEE
• Charge prevailing commission rate • Split between firms cooperative sale: • usually 50%/50% • ranges from: • 66% listing firm/33% selling firm to • 33% listing firm/66% selling firm • Split between firms and agent: • sometimes 50%/50% • offer varies from firm to firm	• Charge commission rate from 2% below prevailing rate to 1% of sales price • Split on cooperative sale: • may give traditional broker cooperative share and keep remainder, when discounter lists. • often rebate seller difference between traditional commission fee and discount commission fee on a traditional listing. • usually belong to both MLS and local Board of Realtors.	• Charge one standard fee for service, ranging from $600-$900. • Split on cooperative sale: • traditional broker almost never cooperates. • usually rebate seller difference between traditional commission fee and the flat fee on a traditional listing. • usually do not belong to MLS or local Board of Realtors

Flat-Fee Firms

Flat-fee firms charge one standard fee for services. Nationwide, the fee can range from $600 to $900, although some flat-fees are much lower. Some flat-fee firms use an inverse sliding scale based on the proportionately increasing cost of the house. Further, many flat-fee firms collect their fees regardless of the ultimate disposition of the property.

Co-brokering with traditional firms is especially difficult for flat-fee firms, particularly when the flat-fee does not belong to the MLS or the local Board of Realtors. On a flat-fee listed home, the traditional broker may not be willing to cooperate. Consequently, the flat-fee firms generally sell their own listings. If a flat-fee firm does sell a traditional firm's listings, the flat-fee broker usually refunds to the seller the difference between the traditional commission split and the flat-fee charged.

Services

The actual services provided by brokers to customers are, along with pricing, a second major distinguishing characteristic of real estate brokerage. As with pricing, the service package rendered by traditional firms appears relatively uniform across the United States. What is particularly noteworthy is that the services offered by some alternative firms--at lower rates--do not differ substantially from those offered by traditional firms. The major difference is the level of effort devoted by the firm to the showing function. Generally, alternative firms perform a reduced showing function for their lower brokerage fee.

Exhibit II-3 presents the provision of services by firm type.

Traditional Firms

The traditional firm offers brokerage services to clients in a "bundled package." This refers to the fact that the client must purchase all the services or none, and the broker usually will not negotiate individual or reduced services. Some firms, however, may offer additional services, such as an equity advance or a loan commitment to a qualified purchaser for an extra one percent. The basic services may be divided into three categories: listing, showing, and closing.

During the listing process, a firm promotes itself to a seller and attempts to obtain the right to broker the transaction for the seller. Since most traditional firms promote their reputation and quality of service, the seller must use additional criteria to choose a lister. The criteria seem to include the development of an appropriate pricing strategy for the property.

Firms, therefore, aid in the price determination by suggesting a listing price, generally based on market information. There may be several ways in which a firm helps establish a price. At this point, it is sufficient to

EXHIBIT II-3

PROVISION OF SERVICE BY FIRM TYPE

TRADITIONAL FIRMS	DISCOUNT FIRMS	FLAT–FEE FIRMS
Services offered in 'bundled package' include:	Services offered in 'bundled package' may vary and can include:	Services offered in 'bundled package' are limited and can include:
Listing Services	Listing Services	Listing Services
● appraisal of home ● placing listing on MLS ● other cooperative efforts to locate buyers ● additional non–MLS advertising of the home	● appraisal of home ● placing listing on MLS if firm is a member ● agreement to vary commission to entice traditional firm to show property ● non–MLS advertising	● appraisal of home
Showing Services	Showing Services	Showing Services
● finding/screening potential buyers ● holding "open house" ● arranging appointments to show home ● promoting home to individual buyers: encouraging purchase of home	● providing seller with signs, flags, sample advertising, and advice on showing ● giving buyer list of appropriate homes to see	● providing seller with signs, flags, sample advertising, and advice on showing ● giving buyer list of appropriate homes to see
Closing Services	Closing Services	Closing Services
● facilitating and aiding negotiations between buyer and seller ● helping locate financing, mortgage insurance, title insurance, fire and hazard insurance, termite companies ● helping with other aspects of settlement, depending upon the laws and real estate customs in the particular area	● providing sample sales contracts and assist in negotiations between buyer and seller ● helping to arrange required settlement services	● often, closing services are not provided ● some firms offer assistance for an additional fee

note the firm performs an appraisal function (albeit informal) to assist in setting a price. Seller satisfaction with that appraisal is key in the firm selection process.

Showing services performed by a traditional firm include:

- placement of the listing on the MLS and/or other typical advertising means;
- finding and screening potential buyers; and
- holding open house and showing the property by appointment.

The closing service includes concluding the sale by encouraging the seller and buyer to agree on common terms and assisting in the organization of the settlement process. Once a contract is ratified, the selling firm (broker or agent) generally will assist the purchaser in securing permanent financing and in removing other contingencies on which a contract may depend. The firm may also assist in the location of a settlement agent, termite inspector, and other required participants.

Discount Firms

Discount firms also offer bundled packages of services. Whereas traditional firms tend to offer a single package of services, discount firms may offer different packages at different prices. Further, it appears that a discount firm may be more inclined to vary service and price than its counterpart, the flat-fee firm. In general, differences between traditional, discount, and flat-fee firms surface in the listing and showing functions.

While methods used to obtain listings may not differ significantly among firm types, the trade-off between obtaining a listing and the listing price appears more critical for the discount firm than for the traditional firm or for those flat-fee firms that receive their fee regardless of whether the property is sold. Inventory turnover is important to all firms; however, the discount firm may be more sensitive to its inventory turnover ratio because of its constrained pricing structure and reduced profit margins. The discount firm may, therefore, attempt to obtain a more realistic listing price from a seller and may not be able, in all cases, to yield to the expectations of the seller.

In terms of the showing function, discount firms tend to offer fewer services than their traditional counterparts but more services than generally are offered by flat-fee firms. The services frequently include the provision of signs, examples of newspaper advertising and sample contracts, and general advice about techniques to use when showing a home. The discount firm will also direct potential buyers to a seller but, generally, will not drive buyers to different homes. A discount firm may also vary the efforts applied to the showing function based on whether the property being shown is listed with the discount firm. Generally, greater effort is applied when the firm also generates the listing. For example, the discount firm will often accompany a potential buyer to its own listed properties. This makes sound economic sense as the largest commission is earned by the firm when it sells its own listings. One should expect to observe similar behavior among traditional firms because the same incentives are available.

Flat-Fee Firms

Flat-fee firms tend to offer a fixed and limited set of services. These services must be targeted at a market segment that is different than those markets pursued by most traditional firms. The services offered by flat-fee firms appear most appropriate for those sellers seeking to minimize their selling expense and willing to perform nearly all of the functions necessary to attract a buyer and conclude a sale.

For the flat-fee firm, the listing process hinges on the firm's ability to attract sellers to this type of firm and to agree with the seller on a specific listing price. If the firm's fee is not contingent on the sale of the property, then the listing price is not as significant as it is for other firms. However, many flat-fee firms do operate on a contingent fee basis and, therefore, cannot afford to accept many unrealistic listing prices. Once the seller agrees to list his or her home with the firm, the set of services are provided to the seller. These services generally include "in-office advertising" and a package of materials (e.g., signs, advertising copy) to assist the seller in performing his or her newly acquired functions.

The flat-fee firm generally provides limited showing assistance through its "in-office advertising." This service includes maintaining pictures and facts about the property and showing them to potential buyers. Otherwise, the showing function remains the primary responsibility of the seller.

In terms of providing settlement-related assistance, the flat-fee firm may not have any responsibility. Whereas traditional and discount firms provide assistance during this phase as a matter of course, the flat-fee firm typically may charge a fee if it is required to provide assistance.[1]

Employment Methods

A third feature that differentiates firms in the industry is the method by which agents are engaged by their firms. Typically, traditional agents:

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[1] Since flat-fee firms may not participate in settlement, it is likely that the uniform settlement form may not contain an entry for brokers commissions when flat-fee firms are brokers.

- contract independently with the firm; and
- receive compensation through commissions.

Often, discount firms use a similar method. In contrast, agents of a flat-fee firm generally:

- are direct employees of the firm; and
- receive compensation through salaries.

The traditional agent's contract with the firm gives the agent the opportunity to earn as much income as his skill and effort will bear. This arrangement also allows the agent to maintain flexible work hours which may be a contributing factor to the number of part-time agents in the industry. However, both the agent and the firm incur a risk in meeting profitability goals established by either party, as neither can depend upon a steady source of income.

The flat-fee firm offers its agents a steady income through a paid salary, but the agent's hours are less flexible and his income potential may be reduced. This appears consistent with the notion of risk and reward. Because the flat-fee agent is not compensated based on sales, his risk is reduced and, potentially, so is his income.

A second employment characteristic of the flat-fee firm is its inclination toward functional specialization. Often, an employee is assigned a function (e.g., obtain listings) and does not, therefore, participate in the entire sales process. The limited exposure provided to the employee may be a firm strategy directed at maintaining staff. By limiting exposure, the employee may not have as many opportunities to change positions as do traditional agents. This appears consistent with the risk burden assumed by the flat-fee firm through the provision of a salary to its employees. It also seems consistent with the relative investments made by each firm type.

Several large national companies (e.g., Merrill Lynch et al. and Sears Roebuck) have started to acquire real estate brokerage firms in various parts of the country. These acquisitions appear to be logical targets for some conglomerates for several reasons. First, these companies have internal capital for acquisition and operations, sophisticated management skills necessary to improve multi-office operations, access to mortgage financing, and name recognition and reputation. Second, these firms have the capacity to expand services beyond those typically provided. These services might include easier access to financing, relocation assistance, all types of insurance, home warranties, and home services such as new appliances and repairs.

Several implications of this trend may affect service delivery. These large companies may improve service to the consumer because of their better management capacity, access to capital markets, and added services. Both national and franchise companies, for example, can offer inter-area relocation services. Thus, a consumer moving from one city to another can engage one company to provide listing and selling services, where appropriate, at each location. The firms also may be in a better position to provide interim financing if one property has not been sold while the consumer must move to his or her next location.

An adverse consequence of this trend may be the inability of small local companies to compete. If national companies capture a growing share of buyers and sellers, then the demand for local companies may decrease. As a result, the range of available services may also decline and buyers and sellers may be left with fewer alternatives for purchasing services. The reduced competition may also influence future pricing in the industry.

NEED FOR BROKERAGE SERVICE

The brokerage industry's function is that of an intermediary: to bring together sellers and buyers. For most consumers, this function provided by the industry is an important one for several reasons.[1]

Individual industry members, in general, have experience in the transfer of real property, have market knowledge, and have access to information not easily accessed by the average consumer. Experience is critical because most consumers rarely buy or sell a house. Because this event is rare, it often pays the consumer to employ someone to see that the sale or purchase is performed properly.

Market knowledge is important because of the localized nature of realty. Buyers from out of town do not know preferred residential locations nor value and, therefore, require assistance. Similarly, sellers often have sales price expectations that are not realistic.

Because the brokers are regularly involved in transactions, they are in a better position to recommend a specific sales price. The broker can also suggest a few household improvements that can assist in the sale. These benefits are particularly important when the seller must sell within a constrained period of time.

Market knowledge and information are inseparable. The broker has access to sales information (e.g., past sales, current listings) as a result of his participation in the market and through studying MLS reports. This information, while sometimes provided selectively, can be used to the advantage of both buyers and sellers.

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[1] This brief discussion avoids the pricing vs. service issue, which will be explored in Part 3.

The combination of experience, firsthand market knowledge, and information permits the brokerage industry to play an important part in the purchase and sale process experienced by the consumer. While use of an intermediary does entail substantial costs, the purchase/sale process occurs infrequently and, apparently, most consumers prefer not to conduct it by themselves.

INDUSTRY CHARACTERISTICS

Several important findings emerge from an analysis of available data related to this industry:

- The continuing increase in the dollar volume of existing home sales suggests there is a growing pool of commission dollars being earned by the industry, which may be the reason for the continued growth of industry participants.
- Small firms still dominated the industry in 1976-77, suggesting that on a national scale the historical situation of low firm concentration, small market shares, and few barriers to entry may still be present.
- The limited available data make it very difficult to provide hard factual information about this industry or to quantify trends.

Home Sales And Commissions Earned

Exhibit II-4 illustrates the rapid rise in both the number of homes sold and the price of existing single family homes sold during the 1968-1979 period. Since commissions paid are computed as a percentage of sales, commission revenue also has increased substantially.

These increases suggest a valid reason for the increase in the number of real estate practitioners that continues to occur each year. The increasing pool of commission revenue apparently is sufficient inducement for individuals to become sales agents or brokers.

Number Of Licensed Brokers And Agents

Although the NAR membership lists include 200,000 brokers and 400,000 sales agents, the actual number of licensed brokers and agents in the country is not known. The National Association of Real Estate License Law Officials (NARELLO) has published statistics on numbers of brokers and agents (see

EXHIBIT II-4

EXPENDITURES AND UNITS SOLD FOR EXISTING SINGLE-FAMILY HOMES. 1968-1979

YEAR	DOLLAR VOLUME OF EXISTING SINGLE-FAMILY HOME SALES (U.S.) (BILLIONS OF DOLLARS)	NUMBER OF EXISTING SINGLE-FAMILY HOME SALES (U.S.)	AVERAGE PRICE OF EXISTING SINGLE-FAMILY HOME SALES
1968	$ 35.0	1,569,000	22,307
1969	37.8	1,594,000	23,714
1970	41.4	1,612,000	25,682
1971	56.5	2,018,000	27,998
1972	67.8	2,252,000	30,107
1973	76.8	2,334,000	32,905
1974	81.3	2,272,000	35,783
1975	95.6	2,452,000	38,989
1976	126.7	3,002,000	42,205
1977	171.1	3,572,000	47,900
1978	216.1	3,905,000	55,339
*1979	233.3	3,704,000	62,986

*Annualized Average for First Seven Months of 1979.

SOURCE: "Existing Home Sales," a Report of the National Association of Realtors. August, 1979, pgs. 4-7.

Exhibits II-5 and II-6), but these data, by NARELLO's own admission, are inaccurate because state tallies of numbers of brokers and sales agents are inconsistent. Some states include both active and inactive agents in their totals, and other states count only active agents.

We further have noted vast inconsistencies within certain states in their year-to-year total figures on brokers and sales agents. One example is Massachusetts, which lists 94,052 licensed brokers in 1975 and 5,597 licensed brokers in 1977. There are several other cases where similar discrepancies occur.

The utility of these data is limited, and we caution against relying on NARELLO statistics for policy-making purposes. This situation underscores the need for wide-ranging efforts to compile accurate statistics on the brokerage industry.

Given these limitations, the data do suggest strong growth in the industry as measured by the number of licensees. Several factors contribute to this growth in addition to the previously mentioned increases in total dollar sales volume of existing single family homes. These factors include the relatively easy entry and exit and the inherent flexibility in work schedules enjoyed by the worker through his/her independent contractor status.

Percentage of Firms Having Fewer Than Five Offices

Evidence of small firms' dominating the industry is supported by NAR statistics, which reveal that a majority of the respondents (63 to 64 percent) were single-office firms, as is shown in Exhibit II-7. More significantly, 93 percent of the respondents were firms with fewer than five offices. Since these respondents were drawn from a pool of realtor firms considered larger and better run than typical real estate brokerage businesses, we may surmise that the industry as a whole has a greater proportion of small firms than is indicated by the NAR data. Low concentration of firms and small market shares would seem to typify the industry at the national level. This characteristic, however, may not necessarily hold true in regional or metropolitan sites, where larger local firms may have comparatively greater market shares than the typical firm on a national scale.

Percentage of Agents Working Part Time

The independent contractor arrangement and commission compensation plan that typify traditional real estate brokerage practices are conducive to part time employment by agents. We might therefore expect a large number of people seeking only part time employment to comprise a significant portion of the real estate brokerage work force. However, NAR statistics reveal that only 26.3 percent of all agents work part time, leaving a full time agent work force of 73.7 percent (see Exhibit II-7). Again, these are national statistics for "better than average" firms, whose greater potential for business opportunities may possibly either attract agents interested in real estate brokerage as a vocation or induce part-timers to enter the industry on a full-time

EXHIBIT II-5

NUMBERS OF LICENSED BROKERS AND SALES AGENTS

1962-1964

1968-1976

	TOTAL LICENSED BROKERS	TOTAL LICENSED SALES AGENTS
1962	321,905	388,357
1963	308,879	358,432
1964	319,471	358,431
1968	393,798	468,652
1969	411,816	506,178
1970	411,630	557,613
1971	435,200	613,614
1972	479,820	726,342
1973	507,563	851,991
1974	553,313	949,757
1975	593,782	965,815

SOURCE: Summaries of License Law Statistics 1970-1976.
National Association of Real Estate License Law Officials.

EXHIBIT II-6

NUMBERS OF LICENSED BROKERS AND SALES AGENTS, 1970-1977, FOR EIGHT MARKET STATES

	LICENSED BROKERS							LICENSED SALES AGENTS						
	1970	1971	1972	1973	1974	1975	1976	1970	1971	1972	1973	1974	1975	1976
California	66,001	68,011	69,937	73,182	72,992	77,871	88,132	100,305	100,609	121,995	146,864	148,435	151,496	174,104
Colorado	3,946	4,130	4,733	5,529	5,950	6,554	7,760	11,783	13,167	17,054	19,548	21,120	22,626	24,065
Washington, D.C.	3,000	2,674	2,811	2,886	2,824	2,833	2,976	3,200	2,542	2,945	3,332	3,188	3,469	3,595
Florida	12,630	14,503	21,991	17,490	25,358	30,716	22,699	33,778	34,646	36,701	53,352	79,553	76,512	89,971
Massachusetts	48,023	54,817	60,000	54,926	70,000	94,052	—	7,444	8,857	16,000	8,393	19,000	25,689	—
Missouri	10,955	11,923	13,601	4,408	12,375	12,460	10,464	15,328	17,635	20,315	22,000	22,889	22,213	23,764
Texas	27,177	27,817	28,445	31,079	33,540	35,779	33,954	28,629	33,885	42,128	60,734	65,901	65,709	60,774
Washington	1,198	5,497	5,450	5,500	6,228	6,147	5,806	4,066	10,667	9,464	9,500	21,390	11,207	13,742

SOURCE: Summaries of License Law Statistics, 1962-1964, 1968-1975.
National Association of Real Estate License Law Officials.

EXHIBIT II-7

SELECTED STATISTICS ON LOCAL AND STATE REALTOR BOARDS AND ASSOCIATIONS, MULTIPLE LISTING SERVICES, BROKERS OFFICES, AND COMMISSIONS PAID TO BROKERS

DATA ELEMENT	STATISTIC
1. Total Number of Local Boards of Realtors	1780
Total Number of State Associations	50[1]
2. Total Number of Multiple Listing Services	1500 (est)
3. Total Number of Local Boards of Realtors Operating an MLS	900 (est)[2]
4. Percentage of Real Estate Brokers Having:	
• 1 Office	63.4%
• 2 Offices	16.8
• 3 Offices	8.6
• 4 Offices	4.3
• 5 Or More Offices	6.8
Total	100.0
5. Percentage of all Residential Sales Agents Who Work Part-time	13.3%[3]
6. Total Dollars in Commissions Paid to Brokers:	
1968	$ 3.0 bil (est)
1977	$10.1 bil

[1] *Supplemental Operations Manual*, 1979. National Association of Realtors. January, 1979, p. 113.

[2] NAR, *op. cit.*

[3] *Ibid.*, p. 37.

basis. It is also possible that in certain market areas where the business is particularly healthy, more people may wish to work only occasionally, merely to supplement income.

Total Number Of Boards Running A Multiple Listing Service

The NAR Department of Economics and Research estimates that about 900 of the 1,500 existing MLSs--or about 60 percent--are run by a local board of realtors (see Exhibit II-7), leaving 40 percent of MLSs independent from a local board.[1] This may indicate that there is less control over MLSs by the local board of realtors--and the NAR--than is generally believed. Less control by the local boards may potentially result in more freedom of access to the MLS by non-NAR members. Increased availability of information contained in the MLS could enhance competition among all firms in a given area. However, whether or not MLS independence from the local board results in increased MLS access and competition depends upon the membership requirements and regulations of the particular MLS. If the independent MLS mandates broker or agent affiliation with the local board of realtors as a condition of MLS membership, access to that MLS may be as restricted as it would be were it run by the local board itself.

Net And Gross Income And Owner's Cash Flow

Income statistics on real estate brokerage firms reveal that firms vary widely with respect to the net income reported. Exhibit II-8 shows that although the median net income of all firms was $14,235 in 1977, average net income ranged from $3,014 for firms in the lower quartile up to $39,210 for firms in the upper quartile. Similar ranges between lower and upper quartile figures exist for firms categorized as corporate or noncorporate, and franchised or nonfranchised.

The firm performance statistics in Exhibit II-8 indicate that, in general, firms organized as corporations are more profitable than sole proprietorships or partnerships. In terms of median gross income, corporate firms earned $300,000, compared to $176,810 for noncorporate firms (partnership or sole proprietorships). Pretax net income, too, is higher for corporate firms, whose median figure was $15,393, compared to $11,965 for noncorporate firms.

A more in-depth indicator of greater profitability for corporate firms is that of owner's cash flow. Owner's cash flow equals pretax income, any commissions or fees received by the owner for his own listings or sales and salaries paid to owners for performance of managerial and other nonselling tasks. Again, using this profitability measurement, we find that the median corporate owner's cash flow exceeds that of the noncorporate owner's by $16,591--or $52,433 for corporate owners compared to $35,854 for noncorporate owners.

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[1] Interview with NAR Department of Economics and Research, October 17, 1979.

EXHIBIT II-8

SELECTED INCOME STATISTICS FOR REAL ESTATE BROKERS, 1976-77

DATA ELEMENT	ALL FIRMS		CORPORATE STATUS				FRANCHISED STATUS			
			CORPORATE		NON-CORPORATE (PARTNERSHIP OR SOLE) PROPRIETORSHIP)		FRANCHISED		NON-FRANCHISED	
PRE-TAX NET INCOME										
• Lower Quartile	3,014		2,610		4,458		1,770		3,602	
• Upper Quartile	39,210		41,234		34,137		35,668		40,628	
• Median	14,235		15,393		11,965		13,353		14,235	
• Average	31,519		33,504		26,295		31,654		31,915	
	MEDIAN	AVERAGE	MEDIAN	AVERAGE	MEDIAN	AVERAGE	MEDIAN	AVERAGE	MEDIAN	AVERAGE
Fees and Commissions	$163,000	$352,024	$200,572	$86,479	$98,367	$157,568	$162,735	$289,568	$167,016	$335,348
*Number of Revenue Transactions	NA	NA	295.5	529.0	163.5	234.8	271.0	447.7	250.0	455.4
Net Income Per Revenue Transaction	$56	$75	$54	$65	$76	$104	$48	$58	$57	$80
Gross Income	$292,232	$549,774	$380,000	$652,909	$176,810	$367,695	$290,705	$495,071	$300,000	$567,326
Net Income of Firms	$14,235	$31,519	$15,393	$33,504	$11,965	$26,299	$13,353	$31,654	$14,234	$31,915
†Owners' Cash Flow of Firms	$45,215	$71,011	$52,443	$76,807	$35,854	$55,295	$38,640	$63,318	$49,211	$73,786

*"Revenue Transaction" refers to either a listing or a sale, both of which are revenue earning activities (when the listing results in a sale).

†This includes net income and all other salaries and commissions accruing to the owner.

SOURCE: Real Estate Brokerage 1978, Income, Expenses, Profits National Association of Realtors, 1978.

The greater profitability accruing to corporate firms may be due to the corporations' ability to employ more monetary resources, sophisticated management, and better trained agents in their business operations. Alternatively, the explanation may be that owners tend to incorporate their firms once those firms reach a certain size and level of profitability. Both corporate and noncorporate firms for which data are shown tend to be more profitable than average for their types, since the NAR states that the respondents to their survey in general are from "larger and better run" real estate brokerage operations.[1]

Age and Growth of Franchised Firms

The growth of franchising in the real estate brokerage industry seems to be a relatively recent phenomenon, as shown in Exhibit II-9. The NAR membership survey revealed that 73.7 percent of all franchised firms responding to the survey existed as such for less than five years and fully 98 percent have been franchised under 10 years. The largest single block, 27.4 percent of all responding franchised forms, have been franchised for only one year or less.

While they are a relatively new entrant into the brokerage industry, franchise real estate operations are growing rapidly. Published data on franchisor's relative size and growth in terms of market share of residential transactions are not available. However, the U.S. Department of Commerce does report data on the size and growth of individual franchises compared to other franchises and the absolute growth in the number of franchises. These data are available only for the years 1977, 1978, and 1979.

Growth in this segment of the industry has been rapid. Where as there were about 7,000 franchises in 1977, there were more than 15,000 by 1979. The annual percentage increase was 65 percent in 1978 and 41 percent in 1979.

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[1] See Real Estate Brokerage 1978: Income, Expenses, Profits. National Association of Realtors, 1978, p.1.

[2] "Franchise Opportunities Handbook", U.S. Department of Commerce, 1979.

EXHIBIT II-9

NUMBER OF YEARS AS A FRANCHISED FIRM 1976-77

*Distribution of Franchised Firms by Number of Years in Existence	% of Firms
1 year	27.4
2 years	16.8
3 years	16.8
4 years	12.6
5 years	8.4
6-9 years	15.8
10 years	2.1

Avg. = 3.4 years

*These statistics are indicative of "better than average" firms in 1976-77. Source: Real Estate Brokerage 1978 Income, Expense and Profit National Association of Realtors 1978.

Summary of Statistical Profile

While the limited data severely constrains analysis, a few points merit attention. In the past, the brokerage industry has grown considerably, probably as a result of the growing dollar volume of existing single family home sales. Total sales volume has increased steadily even during periods when the total number of transactions did not grow as rapidly. Thus, a greater revenue pool has been available for industry participants even though their efforts (as measured by number of transactions) has not always been greater.

While firm and owner income appear healthy, forces exist which may alter industry operations and may hurt the smaller firms, in particular. The major forces include the emergence of national corporations as brokerage owners and the growth of franchises. Both factors may lead to increased national real estate activity and may reduce the utility of the small local firm.

REGULATORY ENVIRONMENT OF THE BROKERAGE INDUSTRY

The brokerage industry historically has not been a highly regulated industry. However, recent trends in consumerism and antitrust law indicate that the regulatory environment of the brokerage industry may be more restrictive now than it has been in the past. An understanding of the real estate brokerage industry requires a knowledge of the regulatory environment within which most brokers work.

This section will discuss four broad areas of law and regulation which impact brokers. The first is common law. While all individuals and businesses are subject to the laws regarding contracts, the real estate broker is involved with agreements and contracts between himself and the seller and between the seller and buyer. The broker assumes a common law agency responsibility. He must be aware of all of the relevant laws and understand how the laws affect his business of selling homes.

The second area is state regulation of the real estate industry. In the past, state regulation has been concerned primarily with licensing procedures and requirements and the definition of unauthorized practice of law.

However, a growing body of trade laws, applicable to real estate brokerage businesses as well as to other firms, are now being passed in many states. These laws are discussed briefly.

Real estate brokers historically have been exempt from federal regulation. Because of the essentially local nature of the transfer of real estate, the interstate commerce clause of federal regulations did not apply. Recent Supreme Court rulings have reversed this interpretation, however. These rulings and their implications for the future will be discussed in a later part of this section. Additional federal regulation of the brokerage business was enacted in the 1968 Civil Rights Act. The Act forbade discriminatory practices such as steering customers to particular neighborhoods on the basis of race, nationality, or similar factors. This act was the first specific application of any federal requirement to the real estate industry.

The fourth regulatory area is the set of guidelines established by the National Association of Realtors. As in many professional associations, investigations of possible violations are instituted through a formal complaint procedure. It is impossible to know whether the guidelines are widely disregarded or are conscientiously upheld.

The regulatory atmosphere within which real estate brokers operate is the result of all levels of laws and regulators. This section contains a basic overview of the most important areas influencing the brokerage activity. Other types of regulation unique to particular states and localities may have an important influence on operations. However, they are beyond the scope of this study.

Common Law

In utilizing the services of the real estate brokerage industry, the seller usually signs a contract creating an agency relationship with the broker. This common law, which is derived from individual cases over time, defines this relationship and specifies the rights and obligations of the parties. Thus, the common law has provided the basic structure which governs the brokerage industry.

Listing Agreements

The contract between the broker and homeowner, frequently referred to as the listing agreement, usually determines most of the obligations of the agency. Such contracts take a number of different forms, including: net listings, open listings, exclusive agency listings, exclusive right-to-sell listings, and multiple listings. The State of Colorado Real Estate Manual provides a brief discussion of each of these contract forms:[1]

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[1] State of Colorado Real Estate Manual, 1979 edition (Chapter III).

- Net Listing. A net listing is a contract to find a buyer or lessee for the property at a certain net price to the owner. For example, the owner may give the broker a net listing of $12,000 on his property. If the broker finds a buyer at $12,000, he receives no commission; if he finds a buyer at $15,000, he earns $3,000 commission. In the latter case, the courts will strictly interpret the listing contract, and if the terms are not clear and definite, there may be a holding that the broker is entitled only to a fair commission and may not keep the full amount above the net listing price when it exceeds the usual commission. The net listing is no longer legal in most states. It is still legal in Washington, D.C., however.

- Open Listing. Under an open listing, the owner lists his property with a broker at a specified price, agreeing to pay a commission on that price or any other price that may be accepted by the owner. However, the owner retains the right to list his property with other brokers. In an open listing, the owner pays a commission only to the broker who sells the property. If the owner sells it to a buyer whom he himself procures, he is not obliged to pay compensation to any broker.

- Exclusive Agency Listing. Under an exclusive agency listing, the owner agrees that the commission for the sale will be payable only to the broker named in the listing agreement and agrees also that the property will not be listed with other brokers. However, if the property is sold by the owner to a buyer whom he himself finds, the broker is not entitled to a commission.

- Exclusive Right-to-Sell Listing. An exclusive right-to-sell listing is like an exclusive agency listing in all respects, except that the broker is given the sole and exclusive right to sell the property during the listed period. Even if the owner himself should sell the property to a buyer, the broker is entitled to a commission. In general, it is common for all listings to provide that if the property is sold within a stated period of time after the expiration of the listing to any party with whom the listing broker negotiated and whose name was revealed to the owner by the broker, the owner must pay the broker his commission.

- Multiple Listing. Technically, a multiple listing is not a separate kind of listing. Generally, it is an exclusive right-to-sell listing, with the additional feature that other participating brokers may also sell the property as subagents of the listing broker. Brokers, usually members of local real estate boards, combine their interests through the facilities of a central listing bureau. Any broker who is a

> member of a multiple listing exchange may sell any property registered with the exchange. When the property is sold, the listing broker and the selling broker divide the commission according to the multiple listing exchange agreement.

Clearly, exclusive contracts are to the broker's[1] best advantage. Under such agreements, the listing broker can reasonably expect to receive payment, regardless of the actual sales effort expended. This apparent incongruity is partially addressed by the argument that it is only the assurance of payment that enables a broker to spend the money necessary to organize the most effective sales efforts. Certainly, it is the listing broker in an exclusive contract who arranges for advertising and open houses. There is some question as to who would be willing to bear these financial costs in an open listing agreement. There is a more substantive question as to whether the value of advertising and open houses is worth eliminating or reducing the open listing incentives, which maximize the number of brokers who are actually showing the house to prospective buyers. Under an exclusive right-to-sell contract listed on an MLS, a usual broker agreement is to evenly divide the commission between the selling agent and the listing agent. The listing agent is thus in a position to obtain half of the total commission for doing nothing more than listing the house on the MLS. It is of considerable concern if sellers are unable to obtain, or even bargain for, listing agreements which they decide best serve their interests.

Agency Law

The agency relationship created by the listing agreement gives rise to two sets of duties: those running from the principal (seller) to the agent (broker); and those running from the agent (broker) to the principal (seller). Insofar as the principal's obligations are concerned, the seller has three basic duties to the broker. The seller must not interfere with the broker's good faith efforts to perform the agent's obligations; the seller must see to it that the broker is compensated according to the terms of the contract and must perform, in good faith, the remainder of the written obligations set forth in the listing agreement.[2]

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[1] There is a distinction between the terms "broker," "salesman," "agent," "subagent," and "realtor," established both by professional associations and state licensing statutes. The generic term "broker" is used in this report to adequately identify all of these members of the brokerage industry.

[2] The common law concept of agency also imposes upon the principal the additional obligations to reimburse the agent for expenses and to indemnify the agent for losses. However, the seller does not bear these obligations in the typical real estate agency situation. Instead, the broker receives all compensation at the time of sale, as a percentage of selling price, from which the broker extracts any "reimbursement" or "indemnification."

Having entered into a listing agreement with a seller, a broker assumes the four common law duties of an agent to the principal:

- good faith performance;
- reasonable care;
- loyalty; and
- accounting for all funds received.

These basic obligations are frequently supplemented, codified, and enforced by state and federal law and by professional guidelines established by the brokerage industry.

Certainly a broker has a duty to make all reasonable efforts to obtain a buyer. The law judges the reasonableness of such efforts by the standards of competency established by the industry within that community. The broker is also charged with a similarly determined standard of care in advising the seller and in protecting his interest and property from loss.

The broker's duty of loyalty includes avoiding any conflicts of interest. A common appearance of conflict of interest occurs when a broker works to find a house for a particular buyer. The buyer may believe that the broker is working for him. Loyalty prohibits a broker from representing both the buyer and seller in a sale, although it does not prohibit representing two sellers of very similar properties. Loyalty to the seller prohibits the broker from telling the prospective buyer that the seller will accept an offer of less than the asking price. Furthermore, the broker is obligated to keep the seller fully informed regarding multiple offers and prospects.

Finally, the broker has a duty to account to the seller for any funds received. This usually involves the "earnest money deposit." The broker is typically obligated to keep these funds in a separate account to protect against commingling of funds.

Expansion of Doctrines

The obligations of the broker to the seller, whether founded in the listing agreement or in general agency law, are enforceable in a court of law through normal civil proceedings.[1] The field of civil law that governs the actions of the broker has been expanded to include such tort concepts as fraud, conspiracy, interference with contractual relations, and interference with advantageous business relationships.

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[1] They also may be enforced by a state real estate commission.

These doctrines have sometimes been utilized to find a "fiduciary" duty even to a buyer, but usually only in cases involving overt deception, where a broker conceals the buyer's offer and buys the property himself.

The conscientious broker does not have any particular difficulties with the standard duties and obligations that have been required over the years. Rather, the broker must be careful to pay particular attention to new, expansive developments in the common law that prohibit previously common practices. Such developments usually arise from the more exotic tort liability cases.

Many of the concepts embodied by common law duties imposed upon brokers, including contract, agency and tort liabilities, are reiterated within the framework of other regulatory mechanisms. They are most notably codified in the National Association of Realtors' Code of Ethics, in various state licensing laws, and in some isolated state laws designed to address certain, specific problems. These regulatory bodies have undertaken to define the various obligations and to provide for remedies and enforcement.

State Regulation

The authority to determine licensing procedures historically has been exercised by the states, and consequently exhibits the usual variation dictated by local problems and custom. The state judiciaries historically have assumed the responsibility for determining exactly which real estate related services constitute the unauthorized practice of law. In addition to regulations which specifically pertain to the sale of real estate, realtors are subject to general laws such as unfair trade practices. All of these areas will be discussed below.

Licensing Laws

By far the most comprehensive components of the regulatory environment of the brokerage industry are the state licensing laws. Effectively, every member of the industry must comply with the statutory procedures in order to obtain a license and maintain it. Regardless of interstate differences, each set of laws does address the three primary elements of any regulatory plan:

- who is subject to the provisions of the act;
- what activities are specifically required and prohibited; and
- what sanctions are provided, including both remedies and enforcement procedures.

The statutory definition of real estate brokerage generally determines who shall be subject to the provisions of the licensing law. Typically, these laws begin by defining what actions constitute a practice controlled by the licensing act, then describe any number of exceptions to the rule, exempting specific businesses and activities from regulations. Generally, the definitions include anyone who engages in the business of representing others in the transfer of legal interests in real estate and exclude anyone who does not fit the usual concept of a "real estate agent," such as attorneys, lenders, and other providers of settlement services. Although the licensing acts of the selected sample states hold to this very vague generalization, they do contain a number of semantic and substantive differences. Exhibit II-10 presents many of the specific requirements.

The licensing statutes basically establish that anyone falling within the specified jurisdictional definitions must:

- satisfy minimum licensing prerequisites;
- obtain the appropriate license; and
- conduct all brokerage activities in accordance with specified rules.

The statutes also establish a state regulatory commission, which is charged with the responsibilities of formulating more specific regulations, handling the licensing procedures, and enforcing the provisions of the act and the rules of the commission.

The licensing requirements vary significantly from state to state but typically involve some approved formal education, successful completion of an examination administered by the regulatory commission, and payment of fees. Some grades of licenses involve experience prerequisites as well. An overview of the requirements in the selected sample states for the past decade suggests the emergence of several trends, such as:

- an increase in educational requirements;
- an increase in formalization of licensing procedures;
- an increase in fees; and
- an increase in rigorous enforcement of statutes.

As with state licensing standards for most professions, the licensing requirements established by the real estate commissions vary from state to state. The selected sample sites illustrate the differences quite well. Washington, D.C., for example, has no formal educational prerequisites for a broker's license. Texas, on the other hand, requires 225 classroom hours and California demands a minimum of 18 credit hours of approved college level courses. A summary of some of the licensing prerequisites for the sample sites is set forth in Exhibit II-11.

EXHIBIT II-10

STATE LICENSING REQUIREMENTS

STATE/ PROVINCE	SEPARATE LICENSE REQUIRED FOR:						AGENCY REGULATING DEVELOPERS		OTHER LICENSES REQUIRED FOR:			
	ACTIVE BROKER WHO IS OFFICER OF CORPORATION	CORPORATION	PARTNERSHIP	AUCTIONEERS	SALE OF CEMETERY LOTS	MANAGEMENT OF REAL PROPERTY	OUT OF STATE	IN STATE	MORTGAGE BROKERS	MINERAL, OIL & GAS	BUSINESS OPPORTUNITIES	APPRAISALS
California	Yes	Yes	No	Yes	No	Yes, except resident manager	Dept. of Real Estate	Dept. of Real Estate	Broker Sales	Broker	Broker	No
Colorado	No	Yes	Yes	Yes	No	Yes	Colo. Real Estate Commission	Colo. Real Estate Commission & county authorities	No	No	Broker Sales	No
District of Columbia	Yes	Yes	Yes	Yes	No	Yes	Dept. of Housing—Condominium Office	Real Estate Commission	Broker	No	Business Chance	No
Florida	Yes	Yes	Yes	Yes	No	Yes	Dept. of Regulations, Division of Fla. Land Sales and Condominiums	Dept. of Regulations, Division of Fla. Land Sales and Condominiums		Broker Sales		Yes
Maryland	Yes	No	No	No	No	Yes	H.U.D.	Real Estate Commission	No	No	No	No
Massachusetts	No	Yes	Yes	No	No	No	Board of Real Estate Brokers & Salesmen	Board of Real Estate Brokers & Salesmen	Yes, Broker	Federal Securities & Exchange Comm.		No
Missouri	Yes	Yes	Yes	No	Yes	Yes	None	Secretary of State (Corp. Licenses)	Broker	No	No	No
Texas	No	Yes	No	Yes	No	Yes	Secretary of State	None	No	Securities	No	Broker Sales
Virginia	Yes	Yes	Yes	No	Yes	Yes						
Washington	No	Yes	Yes	Yes	No	Yes	Real Estate Division	Real Estate Division	No	Securities	Broker	No

SOURCE Summary of Real Estate Licensing Requirements, 1979
National Association of Real Estate License Law Officials

EXHIBIT II-11

EDUCATION AND/OR EXPERIENCE REQUIREMENTS

STATE/ PROVINCE	LONG-RANGE PROFESSIONALIZATION PLAN	EDUCATION REQUIREMENTS		EXPERIENCE REQUIREMENTS	CONTINUING EDUCATION		APPLICATION REQUIREMENTS						
							PHOTOGRAPH	FINGERPRINTS	CREDIT REPORT	RECOVERY FUND AMOUNT		BOND AMOUNT	
		BROKER	SALESMAN	BROKER	BROKER	SALESMAN				BROKER	SALESMAN	BROKER	SALESMAN
California	Yes	Six 3-unit college-level courses	No	2 years full-time sales experience or BA	For active renewals, 45 clock hours each renewal		No	Yes	No	40M	40M	—	—
Colorado	No	48 classroom hours of Principles of R.E. & R. E. Law plus 24 classroom hours of R.E. Appraisal & Finance	48 classroom hours of Principles of R.E. & R.E. Law	2 years active licensing as a R.E. salesperson or experience equivalent	No	No	No	Yes	No	50M	50M	—	—
District of Columbia	No	No	No	No	No	No	—	—	Yes	—	—	2.5M	1M
Florida	No	45 classroom hours	51 classroom hours	12 months as salesperson	14 hours each 2 years		Yes	Yes	—	—	—	—	—
Maryland	Yes	6 credit courses	45 clock hour courses	3 years	12 hours every 2 years		—	—	Yes	—	—	—	—
Massachusetts	No	30 hours	24 hours	1 year	No	No	—	—	—	—	—	—	—
Missouri	No	40 hours	40 hours	1 year as salesperson in lieu of 40 hours	No	No	Yes	No	No	—	—	—	—
Texas	Yes	225 classroom (15 semester) hours	180 classroom (12 semester) hours	2 years as an actively licensed salesperson with 1-3 years immediately preceding the application	No	No	Yes	—	—	40M	40M	—	—
Virginia	No	Yes	Yes	3 years as salesperson	No	No	—	—	—	—	—	(Nonresidents)	
Washington	No	90 clock hours	30 clock hours prior to second license renewal		No	No	—	—	Yes	Yes	—	—	—

SOURCE: Summary of Real Estate Licensing Requirements, 1979.
National Association of Real Estate License Law Officials.

best copy available

The rules of conduct contained in the state licensing acts frequently are quite extensive, and detailed.[1] They usually reiterate the common law responsibilities of a broker, and supplement them through particular definition of specific procedures and through expansion into different areas of concern. However, the common law principles establishing the duties of a broker basically provide the foundation for the lists of proscribed activities. The specific regulations describe required procedures for the handling of earnest money[2], and place considerable emphasis on attempting to define conflicts of interest, dishonesty, and fraudulent practices. They frequently expand a broker's responsibilities by establishing regulations that also protect home-buyers and the general public. It is important to note that while the states generally hold to these basic guidelines, the actual regulatory systems vary significantly in the definition of the duties of the brokerage industry.

It is of special relevance that some states have contained in their regulations specific provisions that pertain to many of the same problems which RESPA was designed to correct. For example, the Florida Board of Real Estate's Rule 21V-10.13 expressly prohibits "any compensation, fee, kickback, rebate, bonus or other remuneration or valuable consideration, for the placement of...any business transaction which forms a part of, or is incident to" the sale. However, unlike RESPA, the Florida law permits such kickbacks in the event of full disclosure.[3]

Licensing acts tend to provide for a number of different methods of enforcing the established regulations, and consequently provide a number of different remedies as well. Some of these remedies are recoverable in civil proceedings, and some of the sanctions establish criminal liabilities. The regulatory commissions primarily become involved with the purely administrative and disciplinary actions related to the suspension or revocation of the license. Again, the states have addressed these issues with diverse regulatory plans. However, it can be noted that these enforcement provisions have become substantially more detailed in recent years, not only as a result of concern over the ethics of the marketplace, but also in response to due process and equal protection considerations.

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[1] Cal. Bus. & Prof. Code 10176, 10177 (West); Colo. Rev. Stat. 12-61-112, 12-61-114; D.C. Code Enycl. 45-1408 (West); Fla. Stat. Ann. 475.25 (West); Mass. Gen. Laws Ann. ch. 112, 87AAA (West); Mo. Ann. Stat. 339.100 (Vernon); Tex. Rev. Civ. Stat. Ann. art. 65732 15 (4) (Vernon); Wash. Rev. Code Ann. 18,85.230.

[2] Florida, for example, has established particularly exacting accounting procedures, even to the point of specifying the number of columns on accounting sheets and the title of each column.

[3] Careful reading of the statute indicates that this provision does not permit a homeowner to prevent a kickback, since disclosure itself seems to be sufficient to avoid violation. Disobedience of an instruction which prevents the kickback might be proscribed by some general constraints of Florida Statutes 475.25(b), or by the "Duty of Obedience" described in Section 10.07 of the Board of Real Estate Handbook, which is not a rule.

Another provision recently added to some licensing statutes is one for real estate recovery funds. Such funds are established to provide for recovery of damages against brokers who eventually prove to be judgment-proof. Of course, recovery from these funds typically requires that the aggrieved party has already taken the broker to court, obtained a final judgment and attempted to collect from the defendant. Exhibit II-12 shows the sample sites that have established a recovery fund, the upper limit of recovery, and the amount each member of the brokerage industry is required to contribute in order to finance the fund. An important question suggested by the development of state recovery funds is exactly what conditions have prompted this legislative response.

Similarly, it would be interesting to know whether states that enact stricter regulations have experienced a significant reduction in the types of undesirable behavior that the statutes were designed to combat. Some reports have implied that all of the current licensing laws now in effect expressly prohibit the complete range of objectionable activities within the brokerage industry, but that regulatory commissions do not, in fact, provide effective enforcement of the laws.

Unauthorized Practice of Law

Just as the brokerage regulators establish their licensing jurisdiction by defining specific brokerage activities, the regulators of the legal profession establish their licensing jurisdiction by defining what constitutes the practice of law. This function has historically been reserved to the judicial branch of the state government, and enforcement is typically carried out by the bar associations. As the brokerage licensing statutes establish the regulatory environment within the brokerage industry, the Unauthorized Practice of Law constraints define some of the buoundaries of the environment:

> "The potential legal complications [in a real estate transaction] have moved some courts to insist that only the legal profession is capable of adequately servicing the public need...It is clear, however, that courts are not justified in maintaining that the lawyer is the only person with the requisite morality, education, and intelligence to select or draft an instrument with legal significance."[1]

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[1] Unauthorized Practice of Law by Real Estate Brokers in New Jersey: A Call for Compromise," Rutgers Camdem Law Journal, Vol. 2. (1970), at p.339, cf. Arkansas Bar Ass'n v. Block, 230 Ark. 430, 323 S.W. 2d 912 cert. denied, 361 U.S. 836 (1959); New Jersey Bar Ass'n v. Northern N.J. Mortgage Associates, 32 N.J. 430, 181 A. 2d 257 (1960), modified, 34 N.J. 301, 169 A. 2d 150 (1961); Hexter Title & Abstract Co. v. Grievance Comm. 142 Tex. 506, 179 S.W. 2d 846 (1944); State Bar v. Arizona Land Title & Trust Co., 90 Ariz. 76, 366 P. 2d 1 (1961), modified, 91 Ariz. 293, 371 P. 2d 1020 (1962).

EXHIBIT II-12

REAL ESTATE RECOVERY FUND: AMOUNT AND CONTRIBUTION

STATE	MAXIMUM RECOVERY AMOUNT		RECOVERY FUND CONTRIBUTION	
	BROKER	SALESPERSON	BROKER	SALESPERSON
California	40M	40M	—(1)	—
Colorado	50M	50M	10	5
Maryland	—	—	20	20
Missouri	—	—	N/A	N/A
District of Columbia	—	—	—	—
Virginia	—	—	10	10
Texas	40M	40M	10	10
Washington	—	—	None	None
Florida	—	—	—	—
Massachusetts	—	—	N/A	N/A

SOURCE: 1980 NARELLO Annual Report.

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(1) Where a — appears, the relevant data is unavailable.

The state supreme courts have long held the exclusive authority to define the unauthorized practice of law. Some states have enacted legislation specifically permitting brokers to perform certain "legal" functions. Though most courts have tended to view these laws as "advisory," they almost invariably refuse to override them.[1] Not infrequently, the state bar and the brokers' trade associations have reached a compromise through the efforts of a Joint Committee of the two organizations, through less formalized negotiation, or bitterly contested legal proceedings.[2]

An integral part of the service that brokers provide is the negotiation and execution of legal documents, the explanation of the effect of a sale which is an inherently legal transaction, and the conduct of the actual settlement or closing itself. These tasks have led to the development of two doctrines that permit the broker to complete some standard form documents.

The "incidental to business" theory defines those tasks that are necessary and incidental to the services provided by the brokerage industry, while the "simple instrument" doctrine is a more restrictive rule allowing brokers to perform little more than the clerical functions of filling in a limited number of blanks.[3] The states have not settled upon any single rule, nor have they applied semantically identical rules in a substantively consistent manner. The only identifiable pattern seems to be to prohibit the broker from charging a fee for document preparation, and from providing what is rather vaguely and unenforceably referred to as "legal advice."

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[1] Id. at 334. See also State ex rel. Reynolds v. Dinger, 14 Wis. 2d 193, 109 N.W. 2d 685 (1961).

[2] It is of interest to note a call for cooperation between lawyers and brokers. "The effects of a judicial decision prohibiting brokers from drafting some legal instruments can be chaotic. One need only look at the decision and aftermath of State Bar of Arizona v. Arizona Land Title & Trust Co. in which the state supreme court banned the preparation of all legal documents by realtors and title companies, except when acting for themselves as principals. The realtors, enraged at what they considered an unfounded attack by the legal profession, placed the question on the ballot and by an overwhelming four to one majority [passed a constitutional amendment which] removed from the judiciary the power over the practice of law." Id. at 343.

[3] These are usually restricted to "simple factual terms," such as: (1) date, (2) location of the property, (3) identification of the property, (4) price, (5), time of occupancy, (6) reference to promissory note, (7) date of tax allocation, (8) duration of offer, (9) date of acceptance of offer, and (10) reference to the receipt of the note as an earnest money deposit. Terms necessary to complete the financing clause and other requirements, however, are not within the scope of the phrase "simple factual terms." See Martin, "The Standard for Determining Unauthorized Practice of Law by Real Estate Brokers in Ohio, "University of Cincinnati Law Review, Vol. 40 (1970) at p. 326 cf. Gustafson v. V.C. Taylor & Sons, 138 Ohio 392, 35 N.E. 2d 431 (1941).

Those jurisdictions that take a restrictive position on these issues may discourage complete documentation if consumers do not seek the advice of attorneys and brokers are prohibited from preparing documents. In a rather pragmatic decision in Colorado, the court noted that the "public safety" argument advanced by the bar might have been much more persuasive if it had been supported by any indication that licensed brokers had prepared legally defective documents.[1] Certainly, each state licenses both brokers and bar and should be able to adequately ensure that members of both professions are qualified to perform these functions. One must question the value of requiring an individual to complete three years of law school, display an expertise in all areas of the law, and otherwise fulfill all the requirements to become a lawyer in order to be permitted to fill in blanks.

Unfair Trade Laws

Regulations that affect the brokerage industry include "Unfair Trade Laws." Although they do not address settlement practice directly, they are mentioned in passing.

The states have not followed any discernible pattern in either legislation or enforcement of unfair trade laws. However, these efforts provide some evidence that state and federal legislatures are concerned about certain problems with the brokerage industry and perhaps feel that the current regulatory environment is not adequately handling those problems.

Unfair trade law is actually a composite of state, federal and case law which essentially prohibits the use of false, misleading, or deceptive practices in the conduct of brokerage activities. Some regulations attempt to address these issues by listing specific prohibited activities.[1] The Texas Deceptive Trade Practices Consumer Protection Act is an example of such a broad based effort. An important feature of these state and federal acts is that they provide for punitive damages, attorneys fees, and costs. Furthermore, the statute permits the filing of a class action, which has the practical effect of encouraging litigation where the disputed amount may not, itself, be worth enough to one person to justify the expense of going through court proceedings. This type of provision is one statutory response to a situation in which a legislature perceives that current regulations are sufficient, but are not supported by adequate enforcement.

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[1] The court stated: "Though not controlling, we must make note of the fact that the record is devoid of any evidence of any instance in which the public or any member thereof, layman or lawyer has suffered injury by reason of the act of any of the defendants sought to be enjoined. ...We feel...that the advantages...[of granting injunctive relief] are outweighed by the conveniences now enjoyed by the public...." Conway-Bogue Realty Investment Co. v. Denver Bar Association, 135 Colo. 398, 415-16, 312 P. 2d 998, 1007 (1957), quoted in "The Standard for Determining Unauthorized Practices of Law by Real Estate Brokers in Ohio," University of Cincinnati Law Review, Vol. 40 (1971) at 338. The controlling decisions in this field tend not to involve cases in which a broker is sued for inaccurate legal work. Rather, they tend to involve a seller's reporting the allegedly illegal activity by a broker in order to avoid paying a commission, or a bar association's seeking an injunction to prohibit the "legal" activity.

Federal Regulation

While the individual broker may be affected more by the day-to-day regulation of the state licensing commission, it is the increasing regulatory role of the federal sector which threatens to have the more significant effect upon the brokerage industry. Federal regulations are concerned with the social and economic impact of the entire industry rather than with the common law duties of the individual broker. The economics of the housing industry have been subjected to increasing examination, and the broker's role has been addressed not only by RESPA but by federal antitrust decisions.

Federal Antitrust Laws

The recent expansion of federal antitrust doctrines into the activities of the brokerage industry is clearly the most significant development in the current regulatory environment of the industry. The principal components of antitrust legislation include the:

- Sherman Act;
- Clayton Act;
- Federal Trade Commission Act;
- Robinson-Patman Act; and
- Cellar-Kefauver Act.

These statutes, and the regulatory and case law developed from them, address the full range of activities that are perceived as being anticompetitive and unfair, including monopolization, acquisition, restraint of trade, price fixing, and exclusionary tactics. The jurisdiction of the federal authority in this area is generally limited to organizations that either conduct business in more than one state, or have a significant effect upon interstate commerce. Antitrust law is constantly being adapted to changing times and conditions, and one of the recent extensions of antitrust power is against the brokerage industry.

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[1] A regulation established under the aegis of Florida's Consumer Protection law specifically requires a broker to disclose closing costs in writing to a prospective buyer before signing a contract of sale.

The case of McLain v. Real Estate Board of New Orleans[1] is the most important recent development in the expansion of the federal regulatory environment of the brokerage industry. Although the Supreme Court did not actually have before it the issue of whether the alleged commission-fixing activities of the Real Estate Board violated antitrust law, it did decide that the defenses to federal antitrust jurisdiction traditionally and successfully employed by local broker organizations in the past are not legally sufficient to protect the brokers from antitrust regulation.

The Court applied a legal theory different from that which is used in Goldfarb v. Virginia State Bar to establish federal jurisdiction over price-fixing in the legal profession. In McLain, it stated that jurisdiction is established if it can be shown that the brokerage industry has a substantial effect upon interstate commerce. It is especially significant that the activity complained about does not have to have such an effect, only that the brokerage industry itself have an effect upon interstate commerce.[2] The criteria for meeting this jurisdictional standard was specified by the Court:

> It is clear, as the record shows, that the function of respondent real estate brokers is to bring the buyer and seller together on agreeable terms. For this service the broker charges a fee generally calculated as a percentage of the sale price. Brokerage activities necessarily affect both the frequency and the terms of

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[1] 100 S. Ct. 502 (1980).

[2] "To establish the jurisdictional element of a Sherman Act violation it would be sufficient for petitioners to demonstrate a substantial effect on interstate commerce generated by respondents' brokerage activity. Petitioners need not make the more particularized showing of an effect on interstate commerce caused by the alleged conspiracy to fix commission rates, or by those other aspects of respondents' activity that are alleged to be unlawful. The validity of this approach is confirmed by an examination of the case law. If establishing jurisdiction required a showing that the unlawful conduct itself had an effect on interstate commerce, jurisdiction would be defeated by a demonstration that the alleged restraint failed to have its intended anticompetitive effect. This is not the rule of our cases...A violation may still be found in such circumstances because in a civil action under the Sherman Act, liability may be established by proof of either an unlawful purpose or an anticompetitive effect." Id. at 509.

> residential sales transactions. Ultimately, whatever stimulates or retards the volume of residential sales, or has an impact on the purchase price, affects the demand for financing and title insurance, those two commercial activities that on this record are shown to have occurred in interstate commerce. Where, as here, the services of respondent real estate brokers are often employed in transactions in the relevant market, petitioners at trial may be able to show that respondents' activities have a not insubstantial effect on interstate commerce.[1]

The practical meaning of this unanimous decision by the Supreme Court, in a case which drew the active participation of both the United States Department of Justice and the National Association of Realtors, is that the full range of federal antitrust law is now a very active component of the regulatory environment of the entire brokerage industry.

The Multiple Listing Services would be substantially affected. These services, which are frequently owned and operated by the local brokers' trade organization, are one of the most powerful tools available in the listing and selling of residential real estate. There may be restrictions on allowing non-Board members access to MLS listings; and multiple listed property frequently can only be shown by members of the MLS.[2] Restrictions in the use of such services and, correspondingly, restrictions in local association membership will probably be subjected to a rather uncompromising test of reasonableness. Correcting such restrictions may not jeopardize these listing services. Restrictions of the New York Stock Exchange[3] and the Associated Press[4] services were found to be in violation of federal antitrust law, and corrective measures do not seem to have threatened either one.[5]

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[1] Id. at 511.

[2] Austin, "Real Estate Boards and Multiple Listing Systems as Restraints of Trade," Columbia Law Review, Vol. 70 (1970) at 1343, n. 117, C. Grillo v. Board of Realtors, 91 N.J. Super. 202, 209, 219, A. 2d 635, 639 (1966).

[3] Silver v. New York Stock Exchange, 373 U.S. 341 (1963).

[4] Associated Press v. United States, 326 U.S. 1 (1945).

[5] Similarly, state antitrust regulators have already required some Multiple Listing Services to correct unreasonable restrictions, apparently without any harmful effect upon the service. In fact, the National Association of Realtors has established certain policies and guidelines concerning MLS restrictions which, if followed, would be very close to bringing a local MLS into accordance with antitrust standards. "Exclusion from Real Estate Multiple Listing Services as Antitrust Violations," California Western Law Review, Vol. 14 (1978) at 303.

The effect on the actual operations of the brokerage industry resulting from the expansion of federal antitrust law into the local markets cannot be predicted with certainty. The resistance of the industry and the difficulty of determining the intensity and direction of the effects of federal regulations can render the enforcement of this body of law rather elusive. Uniform compliance with such regulations may be prompted by McLain itself, or may result only from aggressive or consistent prosecution.

Antidiscrimination Law

A significant body of statutory, constitutional, and case law in the United States is designed to define and prevent discriminatory practices. One of the more important sources of federal regulation in this area is Title VIII of the Civil Rights Act of 1968, known also as the Fair Housing Act[1]. It specifically addresses the role of housing in seeking to combat discrimination and segregation and expressly prohibits discrimination based on race, color, religion, sex, or national origin, in the sale, rental[2] or financing[3] of housing, and in the provision of brokerage services.[4] The Department of Housing and Urban Development and the Department of Justice have issued regulations supplementing and interpreting this Act, which "prohibits every practice which has the effect of making housing more difficult to obtain because of race, color, religion, sex, or national origin."[5] Proscribed activities include "steering," "channelling," "blockbusting," and preferential advertising or sales tactics. Brokers are required to refrain from any act or word which might be reasonably interpreted as commenting upon the racial characteristic of a neighborhood, including the mention of "bad schools" or in some cases just an unusually heavy solicitation of listings.

Association Guidelines

Local brokerage trade associations enjoy a rather significant role in the regulatory environment of the brokerage industry, both in providing some regulatory effects themselves and in their influence over similar efforts from legislative and administrative sources. These local organizations are frequently affiliated with the National Association of Realtors,[1] which has adopted rules, policies, and a code of ethics for "Member Boards" to follow. The effect of this very important step towards self-regulation varies widely from board to board. A key element in the evaluation of this system is whether brokers do, in fact, comply with the guidelines established by the national and local associations.

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[1] A number of states, as well as cities and counties, have enacted legislation essentially identical to the Federal Fair Housing Act, or otherwise designed to address the same issue. The principles upon which this law is based are now embodied in the common law, state licensing laws, and association guidelines.

[2] 42 U.S.C.A. 3604.

[3] 42 U.S.C.A. 3605.

[4] 42 U.S.C.A. 3606.

[5] Department of Justice, Civil Rights Division's Interpretation of the Civil Rights Acts of 1968 and 1866 as Applied to Equal Housing Opportunity.

> "Whether lobbying for political action, informing the public through advertising of its existence and its public contributions, or endeavoring to improve the competence of members, the activities of the real estate board are expected ultimately to return some form of material benefit to the membership. While the multiple listing service can serve to reduce market imperfections, constituting an obvious benefit to buyers and sellers, it is also designed to expand the sales potential of the individual member-broker."[2]

Membership in the local board is often considered to be an indispensable prerequisite to the operation of a broker's business.[3] The fact that a non-member often cannot make use of the very important Multiple Listing Service may make board membership an economic necessity to a broker. Most boards have imposed somewhat unrestrictive standards for admission to the association, the principal requirement being a valid license from the state, but they do require continuing adherence to their code of ethics and other rules and bylaws. Similarly, the National Association of Realtors requires member boards to adopt the Code of Ethics, and to follow its policies.

The stated purpose of the Code of Ethics is to ensure "competency, fairness, and high integrity resulting from adherence to a lofty ideal of moral conduct in business relations."[4] The articles of the code encompass the concepts behind the state and federal antidiscrimination laws; they include the traditional common law duties imposed by contract, agency, and tort law; and they expand the obligations of the realtor to matters which are either not addressed or not enforced by state, federal, or civil authorities.

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[1] The National Association of Realtors was formerly known as the National Association of Real Estate Boards.

[2] Austin, supra at 1342.

[3] The term "Realtor," for example, is a service mark registered with the United States Patent Office for the exclusive use by members of local boards affiliated with the National Association of Realtors. Non-members may not use the "Realtor" designation, nor may they display the "Realtor" sign.

[4] National Association of Realtors Code of Ethics, Preamble.

Articles 7 and 9 generally require the member broker to avoid misrepresentations and to treat all parties fairly. It can be said that these precepts are the primary source of a broker's obligations to a buyer. This is a matter of some considerable relevance, as it attempts to address the very common situation in which a broker takes a prospective purchaser to see a large number of suitable houses listed on the Multiple Listing Service, advises the buyer, negotiates for the buyer, and generally undertakes an in-fact representation of the buyer, although the broker's technical obligation remains with the listing broker and the seller. Presumably, this imposes a significantly higher standard of conduct upon a broker than has been adopted by other authorities.[1]

Some of the remaining provisions of the National Association of Realtors Code of Ethics are of importance to an economic analysis of the provision of brokerage services. Article 4 requires a realtor to seek no unfair advantage over, and to avoid controversies with, other realtors; Article 5 urges the sharing of information between realtors; and Article 14 specifically requires realtors involved in legal controversy among themselves to submit the dispute to arbitration through the Member Board. The economic impact of such standards of ethics is a matter of considerable concern. Article 6 generates similar relevance to the marketplace as it prompts realtors to make consistent use of exclusive listing agreements.

The Code of Ethics provides the broadest set of standards most applicable to the realities of the current structure of the brokerage industry. The key to the adequacy of the regulatory effect of such constraints is, again, the actual compliance by the industry resulting from enforcement and other factors. Many of these other factors, such as perception of the community and customary business practice, vary among locales. Because Member Boards are associations of brokers, operated by brokers, the day-to-day enforcement activities may tend to involve resolving disputes between brokers, rather than responding to consumer complaints.

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[1] The civil courts have typically limited the finding of a fiduciary duty to a buyer to cases in which the broker has purchased property that the buyer is trying to buy. These instances have typically been supplemented by blatant misrepresentations, concealment of the buyer's offer, resale to buyer at a profit, outright fraud, and other grossly unethical behavior. See "Brokers-Real Estate Brokers' Duties to Prospective Purchasers - Funk v. Tifft, 515 F. 2d 23 (9th Cir. 1975)," _Brigham Young University Law Review_, (1976).

SUMMARY

The brokerage real estate industry is subject to a large body of common law, to state law, and to federal law. Historically, the Federal Government has not been concerned with the real estate brokerage industry. However, the Civil Rights Act of 1968 brought the industry under federal regulation to ensure a national goal of fair housing.

More recently, the Supreme Court has issued an opinion indicating that the brokerage industry may be subject to antitrust regulation. This type of federal control could severely impact the rules of most Multiple Listing Services and many local realtor boards.

III. MORTGAGE LENDING

The mortgage lender plays a central and especially critical role in the residential settlement process. Not only does the lender typically establish the conditions under which settlement will occur, but he is often instrumental in selecting particular providers of necessary settlement services. He is also the individual settlement-related party given the most responsibility to fulfill requirements defined by the passage of RESPA.

This role places the mortgage lender in a prominent and highly visible position in the eyes of the consumer. At the same time, however, the lender is required to fulfill a fiduciary responsibility to depositors, shareholders, and investors for whom the lender may act as correspondent. These represent a dual set of responsibilities that have become compounded by the enactment during the past decade of a number of pieces of legislation that have expanded a lender's performance requirements in fulfilling his lending and settlement responsibilities.

This chapter develops a detailed description of the mortgage financing model and of the role played by the mortgage lender in completing this process. As such, it is principally descriptive, and calls upon many of our observations from among the eight sites where in-depth interviews were conducted. Much of the information presented in this chapter will serve as a basis for: (1) our discussion, in Part 2 of this volume, of issues relating to the level of performance of the residential mortgage financing market; and (2) our consideration of alternatives and the impact they will have upon mortgage lending, which is presented in the third volume of this report.

A mortgage lender perceives his responsibilities in three distinct yet closely interdependent phases. These include: (1) the funding process; (2) the origination process; and (3) the post-closing process. The responsibilities defined by the enactment of RESPA, and the entire settlement-related process that provides the focus of this study, are contained entirely within the second of these, the origination activity. However, as detailed as this phase is, it cannot be considered or evaluated without an understanding of the funding or post-closing activities.

Financial institutions, be they thrifts, commercial banks, or mortgage companies, perceive the origination and settlement process in much the same way. Even across the eight different geographic sites, some practices and responsibilities may differ but the approach toward the residential mortgage origination process is basically uniform and is motivated by nearly identical concerns and objectives.

An understanding of the compensatory structure of the mortgage financing process and the way that financing service is sold or marketed is critical to this analysis. The relationships among and reasons justifying interest rates, discount points and yields are not easily understood by the layman or average consumer. As a result, most home buyers are often bewildered by the fluctuating sets of costs and conditions associated with mortgage rates, commitment terms, and settlement requirements. This section places the lender's revenues or cash flows in their necessary perspective, in order to adequately address market performance in a later chapter.

The regulatory environment in which the mortgage lending industry operates requires that lenders follow detailed and exhaustive practices and that consumer protection measures be followed. Sometimes, however, these measures are inadequately, inconsistently or not comprehensively enforced; some of these variations are reviewed in Part 3. This section describes relevant federal and state statutes and provisions and summarizes the impact these have upon relevant, RESPA-related issues. It is important to note that although commercial banks and thrift institutions (savings and loans and mutual savings banks) are extensively regulated at both the state and federal level, mortgage banking firms are predominantly free from institutional regulation. Mortgage lending practices, however, differ little among these groups. More information describing the impact which RESPA has had upon different institutional lenders is presented in Part 3 of this volume.

In this chapter, the lending industry will be evaluated according to these descriptive headings:

- Description of the Mortgage Financing Service;
- Mortgage Financing Providers;
- Mortgage Market Mechanisms; and
- The Regulatory Environment.

DESCRIPTION OF THE MORTGAGE FINANCING SERVICE

The residential mortgage lending process has undergone substantial transition during the past decade. A number of factors have contributed to this shift, including a major change in attitude toward mortgage debt by both lenders and consumers. However, mortgage lending has by far been most dramatically influenced by the increasing activity of mortgage investors who conduct little or no direct business with the consumer. Mortgage financing, through the conduit of a correspondent or secondary market relationship, has become a more liquid activity, and this has influenced nearly all types of mortgage lenders.

At the outset of this chapter, it is important to define two very distinct roles that will be discussed throughout this analysis of mortgage lending. That distinction exists between the role played by: (1) the institution that originates residential mortgage loans, and (2) the institution that invests in mortgage loans that it either originates or purchases from elsewhere.

Mortgage bankers typically fulfill the first role only. Other types of lenders, including commercial banks and other depository institutions, may fulfill both roles, and these institutions have become increasingly active as investors in mortgages originated by other mortgage lenders. Nearly two-thirds of all the lenders whom we interviewed acknowledged being active buyers or sellers in the secondary market. Prior to a discussion of the mortgage financing process, a brief description of the factors motivating mortgage investment is warranted.

Mortgage Lending and Credit Markets

Mortgage lending is essentially a local market activity; lenders require familiarity with both the borrower and the property, and the ability to easily arrange for appraisals, inspections, employment verifications, and other similar functions. Some lenders do not originate loans on properties located outside of a well-defined radius so that needed servicing activities can be readily performed.

Mortgage financing, however, in the broader sense of providing funds for residential mortgage investment, is subject to no such geographic limitations. Mortgage bankers act as correspondents for financial institutions interested in mortgage investment that may be secured by properties located across the country; thrift institutions, and predominately those in areas of the country characterized by limited home buying activity or by a surplus of depository funds, have also become major purchasers of mortgages secured by properties that may also be located across the country.

There are a number of reasons for geographic differences in mortgage rates, but it is important to recognize that mortgage investors are interested in securing a well-defined, quantitative yield on their investment in residential mortgages. Sometimes qualitative factors such as loan-to-value ratio, property type, or location may influence an investment decision, but lenders generally perceive mortgages as being fungible when they conform to certain, well-defined characteristics.

Appendix B presents a detailed discussion of the role played by the residential mortgage market within the broader framework of the domestic credit markets. Table II of that Appendix illustrates that new annual mortgage debt increased from a rate of $29.9 billion in 1970 to $149 billion in 1978. This was nearly a four-fold increase over the eight-year period. Many factors have accounted for this tremendous rate of growth, and the expansive development of an active and liquid market for mortgage-backed securities and bonds has been foremost among these.

This development, however, has introduced a volatility that mortgage rates had not earlier been subject to. A significant portion of the growth enjoyed by the mortgage market during the past decade has been financed by institutions that are: (1) absent from settlement; (2) absent from any direct contact with the consumer; and (3) primarily interested in the settlement process to the extent that it provides a mortgage instrument that is liquid, of a stated quality (i.e., conforming to certain requirements), and able to produce an expected yield to the investor.

To realize a certain investment yield, institutions such as life and casualty insurance companies; union, corporate and municipal pension funds; trust departments and commercial banks invest in mortgages (or whole loans), mortgage-backed securities (GNMAs and conventional), mortgage-backed bonds and participation certificates. As a result, their interest in mortgage investment is a relative one. That is, these investments are attractive when they provide a desirable return when compared to alternative investment vehicles of a comparable risk, such as government or agency securities, corporate obligations, other fixed income investments, or equity investments. When mortgages no longer provide such a relatively desirable return, these institutional buyers direct their attention toward other types of investments. As a result, mortgage rates have assumed a level of volatility similar to that of other fixed income securities of a similar risk and term.

This development of a group of mortgage investors who do not necessarily participate in the actual lending or mortgage origination process has had a major influence upon institutions that are active primary lenders. Secondary market investors often define terms and conditions required of a loan if it is to be eligible for purchase. These terms and conditions must be fulfilled as part of the settlement process. For instance, conformance to FNMA and FHLMC requirements has become one of the more obvious manifestations of this development, and other subtle influences upon the settlement process exist.

Two noteworthy outcomes can be drawn from this development of a broad, liquid, secondary market that stands behind the primary mortgage lending market. These include: (1) greater standardization of necessary settlement procedures; and (2) greater conformance of local mortgage rates to national yield requirements.

Standardization among lender requirements impacts and, to some extent, defines a lender's need for title insurance, title search, mortgage insurance, a legal opinion, and most of the other services a consumer must pay for as part of the settlement process (appraisal, credit report, pest inspection, hazard insurance, etc.). A portfolio lender, such as a thrift institution or a commercial bank that originates a loan and intends to retain it for its own investment portfolio rather than sell it to another investor, is allowed more discretion in defining settlement requirements. However, responses to our questionnaire indicated little differences among loan characteristics between portfolio loans and those sold to secondary market investors.

Exhibit III-1 identifies a number of characteristics describing a residential mortgage. Among those lenders whom we interviewed who were active in the secondary mortgage market, a very high proportion (over 90 percent) said that there was "no difference" in requirements between portfolio loans and

EXHIBIT III-1

PERCENT OF RESPONDENTS ATTRIBUTING NO DIFFERENCE TO CHARACTERISTICS OF PORTFOLIO LOANS AND LOANS SOLD TO SECONDARY MARKET INVESTORS

CHARACTERISTIC	PERCENT OF RESPONSES IDENTIFYING "No Difference"
Interest Rate	80.4
Required Points	92.9
Maturity (Term)	93.8
Minimum Loan-To-Value Ratio	85.6
Appraisal Requirement	97.3
Credit Report Requirement	98.2
Title Insurance Requirement	99.1
Mortgage Insurance Requirement	94.3
Prepayment Penalty	81.8

SOURCE: PMM&CO. Lender Survey, February 1980.

those loans that would be sold to other investors. Of the listed characteristics, only three items -- minimum loan-to-value ratio, the imposition of a prepayment penalty and the mortgage coupon rate -- differed among as many as 20 percent of the respondents.

More variation probably occurs among lenders not active in the resale of mortgages to other investors, and it is certainly more common in non-metropolitan areas where local custom often outweighs a need to conform to certain nationally representative standards. The point remains that the development of a broad and liquid market for purchasing residential mortgages has contributed to greater standardization in origination requirements, and it has removed from the primary lender some of the responsibility and even some of the discretion for determining necessary settlement services.

A second result of this secondary mortgage market has been an overall decrease in mortgage rate variability across geographically distinct markets. Mortgage lending has traditionally been a local market phenomenon. As a result, competitive practices and local mortgage rates have been influenced primarily by (1) tradition; (2) the level of local demand for mortgage financing; and (3) the availability and cost of local depository funds for mortgage investment. Local supply and demand conditions, as well as both average cost of funds and expected future cost of funds, substantially influence and determine local mortgage rates. Because of this, a prime mortgage rate in Massachusetts, Kansas, or Florida might be noticeably lower than the rate charged for an identical loan in a major metropolitan area or in an area experiencing significant growth or a heavy demand for investment funds.

Although interregional variations in mortgage rates still occur[1], a more efficient secondary market has made them less pronounced. A savings bank in Massachusetts, for instance, may still make some loans at rates that are below national levels, but that savings bank will also use available funds to invest in higher yielding mortgages available in the secondary market. The decision to lend locally is motivated out of an interest to serve depositors and a local market area. However, a decision to invest in higher yielding mortgages secured, for instance, by California condominiums, is an economic one, and at times these two motivations come into conflict.

The Funding Process

Although residential mortgage lending is subject to the traditional and customary practices that are followed in a particular area, all lenders face the common obstacles of obtaining funds with which to finance home purchases.

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[1] W.A. Longbrake and M.O. Peterson, "Regional and Intra-regional Variations in Mortgage Loan Rates," Journal of Economics and Business, Winter 1979.

Depository Lenders

Thrift institutions finance mortgage origination activity with deposits and repayments, and when necessary and available, through borrowings from other institutions. By nature of their state or federal charters, these savings and loan associations are required to maintain a certain high percentage of their assets in residential mortgages. Thrifts, therefore, lack the flexibility of other institutions to invest in alternative, non-mortgage related instruments. Savings banks have more discretion to invest in bonds and equities than do S&Ls, but as a group, these banks typically have about 60 percent of their assets committed to mortgage investments.

Commercial banks also finance mortgage investments predominantly through deposits and other borrowings, but these banks are not mandatory mortgage lenders to the extent that thrift institutions are. Commercial banks must maintain a loan portfolio that provides a return sufficient to cover the bank's cost of funds, cover its cost of operations, and provide an adequate return for its shareholders. However, residential mortgage investment is only one of a number of alternatives that includes industrial and agricultural loans, consumer loans, or investment in a variety of fixed income securities or stock.

As a result, commercial banks participate in the mortgage market out of a desire for loan portfolio diversification and to provide a financial service to their depositors, customers, and the community. However, during different phases of the economic cycle, commercial banks may maintain different levels of mortgage lending activity that will depend upon the availability of funds and the attractiveness of alternative investments.

Thrifts and commercial banks are the traditional mortgage lenders that finance home purchases with depository funds. Credit unions similarly perform this function, but they represent a relatively small market participant. These institutions are predominantly portfolio lenders: each typically maintains assets or an investment portfolio composed of residential mortgages that the institution has originated, but that portfolio may also include mortgages that have been purchased from other lenders or investors.

Mortgage Bankers

Mortgage bankers operate within a very different environment but remain influenced by nearly the same market conditions that impact depository lenders. That is, when loanable (or investment) funds are available, all of these primary lenders may actively market and advertise to attract home buyers interested in securing financing. When the supply of foreseeable funds diminishes, these lenders may suspend their promotional activities and increase their mortgage rates or qualifying conditions in order to focus upon more desirable (i.e., of a higher yield or of a higher quality) loans.

Mortgage bankers, however, have no deposits and only limited assets. They generally cannot lend their own funds and must rely upon commitments to purchase loans that are issued by other institutional buyers. As a result, mortgage bankers are predominantly mortgage market intermediaries who receive fees to originate loans and fees to service loans for institutional investors who have purchased them.

These buyers may include pension funds, insurance companies, government agencies such as FNMA and FHLMC, GNMA security dealers and sometimes individual investors, as well as depository institutions that are interested in acquiring mortgage investments. The terms or conditions dictated by these investors have a significant impact upon the requirements lenders make of consumers or home buyers.

Commitments To Purchase

The terms of a commitment agreement are an important component of the funding process, and these terms influence both the flexibility or discretion allowed a mortgage lender and his competitive position. Commitments that are issued by investors typically are expressed according to three sets of conditions. These include: (1) the quality of the loan; (2) the required yield to the investor; and (3) the term during which the commitment is effective. From the perspective of the primary lender, these commitments are "puts", or optional rights to deliver mortgages to an investor, but they are not open-ended. Such commitments usually expire if not used or "delivered against" within a period that has traditionally been up to 60 or 90 days, although some do extend longer (FNMA typical commitments, for example, are for 120 days).

In the rapidly tightening credit markets that have been experienced during the second half of 1979 and early 1980, it has been a risky and costly business practice to issue long term commitments. An agreement to purchase over a three month period a package of mortgages at a 10 percent yield, for instance, can be very costly to an investor if credit conditions tighten and comparable required yields have risen to 12 percent. The investor would pay substantially more for a 10 percent mortgage than its market value at the end of the commitment period.

The use of commitments as a source of funds is a sophisticated and risky business activity, and recent volatile credit conditions have encouraged both lenders and investors to reduce their risk by limiting the term during which a commitment is effective. This has had important adverse impacts upon the consumer. First, both a lender and a home buyer may forfeit a commitment if the home buyer is unable to go to settlement within an expected period. The consumer may then become responsible for securing a new commitment, and this may involve more costly or more restrictive terms. Second, the commitment that a lender may issue to a home buyer may contain no stated interest rate, but may instead commit the lender to provide mortgage money at the current rate prevailing at the time of settlement. Under such conditions, the consumer bears the risk of mortgage market fluctuations and he is unable to know with certainty what mortgage rate and what monthly payment he is committing to.

The Origination Process

Data presented in Table VI of Appendix B indicate that savings and loan associations are by far the largest originators of mortgage loans in the country. In 1978, they were responsible for originating 50.9 percent of all residential loans. Commercial banks represent the second largest group, and in 1978 they accounted for 23.4 percent of origination activity. Mortgage bankers ranked third in origination volume that year and accounted for 16.2 percent of single-family originations. They were followed by mutual savings banks, which originated 5.3 percent of the total.

Life insurance companies are major investors in residential loans, but they accounted for only 1.5 percent of origination or primary lending activity in 1978. Other small institutions including credit unions, corporations (who occasionally provide financing for relocated employees), individuals and others accounted for the remaining 2.7 percent of origination activity in 1978.

The origination activity is the second of three that compose the mortgage lending process. It can be evaluated in terms of five distinct tasks, each of which involves substantial consumer contact. As a result, whereas funding can be described as a relatively calculated and formal process, origination is very much a personal one. Differences therefore develop within geographic areas and across lender type due to custom, and they may even develop within a lending institution due to the particular practices of a lending officer. The five tasks comprising the origination process are: (1) solicitation; (2) application; (3) processing and decision; (4) commitment; and (5) closing.

Solicitation

The lender is required to make contact with builders, real estate brokers, and borrowers in order to: (1) inform them of the availability of mortgage money; (2) educate them regarding the type and requirements of loans the lender will make; and (3) provide current market information with respect to rates and terms. This solicitation process is essential if the lender is to minimize the effort required of real estate brokers, sellers, and other lenders to inform them. With such information, real estate agents are able to quickly determine whether a potential buyer is likely to qualify for the necessary financing on a particular property. In this way, they are able to concentrate sales efforts on potential buyers likely to qualify for financing. In turn, most applications to lenders will be from prospective buyers who have a reasonable chance of meeting requirements for financing. This reduces effort and cost and thereby improves the efficiency of the lending/settlement process.

During our interviews, we asked lenders to comment on which methods of developing business and attracting mortgage applicants were generally used. More than 76 percent responded affirmatively that they made contacts with real estate brokers who could recommend their institution; more than 90 percent of the mortgage bankers responded that they generally used this method. Among the respondents, more than 95 percent felt that such a method was effective in developing new business. There was very little difference across sites in the proportion of lenders endorsing this business development method.

Exhibit III-2 summarizes the responses among different lending institutions regarding other methods that were generally practiced to solicit or develop new business. Developing builder contacts was the second most frequently used method; 94 percent of those responding felt that this was an effective method. Among seven other methods that were asked, the highest agreement was expressed for increasing maximum loan amounts as a way of developing new business; 39 percent of the respondents generally used this method. It is interesting to point out that only 8 percent of all lenders generally reduced closing costs as a method of developing new business.

Application

The application process is typically initiated by the consumer or loan applicant and most frequently occurs after a home has been selected and after a contract has been written. Less frequently, potential home buyers may apply first for a loan in order to determine the amount for which they would qualify. Because of this timing, some consumers who sign a contract that is not contingent upon securing financing at reasonable terms, may be liable to forfeiting their deposit on purchase or earnest money if adequate financing cannot be found.

This ordering suggests that the real estate agent plays a very important role in two respects. First, he provides advice to the home buyer concerning the terms of the purchase contract, and second, he is in an influential position to recommend mortgage lenders. This level of influence is supported by the high proportion of lenders who feel agents are effectively used to develop new business.

At the time of application, the consumer is asked to provide the lender with a variety of information describing his (1) employment history; (2) credit experience; (3) income; (4) net worth, liabilities and assets; and (5) his homebuying experience. At this point, the Special Information Booklet is typically provided to the loan applicant. According to our questionnaire, 40 percent of the lenders provided the SIB at or prior to loan application, and 57 percent made the booklet available to the borrower within three days of the application. However, this review process often provides the applicant with an inadequate opportunity to review the booklet and understand the decisions which he may be required to make.

The lender typically assumes responsibility to explain to the consumer the kind and amount of expenses that will be required at settlement. At the time of application, the cost of necessary settlement services will typically be discussed, and the applicant may be invited to participate in deciding who is to provide necessary settlement work. This poses a major impediment that limits the consumer's ability to knowledgeably discuss alternative providers. Often he has only seen the Special Information Booklet for the first time, and typically he will be inadequately familiar with either his needs or his options. Some decisions do not need to be made at the time of application, but others such as the selection of a credit report company, an appraiser and, when

EXHIBIT III-2

METHODS USED BY LENDING INSTITUTIONS TO DEVELOP NEW BUSINESS

Method	Percent of Respondents Answering "Yes" to "Generally Use"				
	Commercial Banks	Savings and Loans	Mutual Savings Banks	Mortgage Bankers	Total
	(n=66)	(n=102)	(n=19)	(n=82)	n=269
Make more contacts with real estate brokers who could recommend your institution	42.7	88.2	68.4	90.2	76.2
Make more contacts with builders who could recommend your institution	45.5	64.7	36.8	75.3	61.2
Increase advertising directed toward consumers	16.9	33.3	31.6	14.8	23.6
Increase the maximum loan amount offered to consumers	26.2	47.1	36.8	39.2	38.9
Reduce the closing cost paid by consumers	3.1	5.9	5.3	14.6	7.8
Increase the length of the mortgage term offered to consumers	7.7	10.8	0.0	3.7	7.1
Decrease the interest rate	15.4	34.3	26.3	18.3	24.3
Increase the loan-to-value ratio	18.5	29.4	15.8	23.2	23.9
Lower other charges by increasing the points paid by the seller	6.2	7.9	21.1	9.8	9.0

SOURCE: PMM&CO. Lender Survey, February 1980.

needed, a mortgage insurer are on the critical path of the lender's review process, and may need to be made quickly.

Also at the time of application borrowers are often required to prepay costs that the lender will incur in verifying provided information. Nearly 64 percent of the respondents to the questionnaire required payment at application to defray the costs of a credit report, and about 65 percent required payment to offset the cost of a property appraisal. There was, however, significant variation in the responses concerning this practice. Lenders typically required such prepayments in Washington, D.C., Seattle, and Denver, but fewer than 45 percent of the Los Angeles lenders and less than 30 percent of the Boston lenders required prepayment of such expenses at the time of application.

A better defined pattern was suggested by the institutional response to this question. More than 90 percent of the mortgage bankers who participated in the questionnaire required payment for either or both of these services at the time of loan application. However, only 58 percent of the savings and loan associations, 54 percent of the commercial banks, and 26 percent of the savings banks required similar payment for these services at the time of loan application. This is a very important practice because the prepayment of these expenses represents a sunk cost and serves as a deterrent to borrowers who might otherwise shop around for better lending terms or for lower overall settlement costs.

Nearly 95 percent of the lenders who were interviewed responded that the good faith estimate was given to applicants within three days of their loan application. Others indicated that the GFE was presented to borrowers around the time that approval was granted, or when the formal commitment letter was sent. There was little variation among lending institutions regarding this practice.

Upon receipt of the GFE, the borrower knows the estimated amount of his settlement costs, but he does not know how these total costs compare to those charged by other lenders. Broad cost ranges that are sometimes given by lenders may disguise the actual cost of settlement and may make comparison more difficult. More importantly, however, receipt of the GFE typically comes after some application expenses have been prepaid; if the borrower then decides to continue shopping for service providers, he may forfeit those prepayments. This significantly reduces the benefits which the GFE was designed to provide.

Processing

Loan processing involves a number of steps, designed to provide additional information and to evaluate risk. The property is appraised only for present value. Information on the borrower is collected, checked, and evaluated; this includes employment and income verification, as well as a credit check on history of debt and payment experience. Then the borrower must be evaluated, with the underwriting process looking at the nature, stability, amount, and trend of income in relation to family obligations, current debt service, and general expenditure patterns.

Other information that is collected includes title status, property status (e.g., survey of property and improvements, termite inspection), property liens, and conformity with laws and regulations for zoning and usage. Checks are made for location of property with respect to flood zones and, in SMSAs, census tracts. Applications for FHA or conventional loan insurance or for VA guarantees are submitted and their progress is monitored until approved or denied.

After these steps have been completed, a lender proceeds to make the decision as to whether or not the loan will be approved. Sometimes this is a mechanical and informal process, but some lenders require that all applications be reviewed by a loan committee, which has responsibility for the final decision on approval or rejection.

If approved, documents may be prepared as a part of this step which provide for good faith estimates, truth-in-lending disclosure statements and possibly preliminary HUD-1 forms. Any of these forms may be sent to the borrower upon formal notification of loan commitment.

Commitment

As a part of the solicitation process, lenders may provide builders with advance commitments for financing on suitable properties. These commitments include specifications for the terms, interest rate, points and the maximum loan amount that will be allowed. These commitments, however, are subject to home buyers' fulfilling lender requirements, and they usually are limited to a defined term or have escalation clauses that allow for changes in market interest rates. The marketing process of builders and real estate agents is facilitated by these advance commitments, but they do not preclude the need for each individual home buyer to qualify for and secure a commitment for mortgage financing.

Once the buyer qualifies for a specific loan amount on the desired property, a commitment letter is issued for financing at a fixed rate and term. In many instances, however, the interest rate and terms are not set until the date of final closing on the property. Viewed from the lender's perspective, two risks are involved: the market may change unfavorably between commitment and closing; and a number of loan commitments will never result in closed loans, and this slippage tends to increase when interest rates are falling.

Of those lenders responding to our questionnaire, only 36.4 percent indicated that a specific interest rate was committed to at the time of application. More frequently, commitments to a certain interest rate will be given within 30 days of settlement (33.9 percent of the respondents), or at the time that an FHA or a VA commitment is received. However, these practices change as a function of mortgage rate expectations; when lenders do commit to a specific mortgage rate, they may typically do so for only a short commitment period.

Closing

The closing or settlement process represents the culmination of all prior related activities. Necessary documents are signed; final insurance and guarantee forms are presented; title to the property passes to the purchaser and is recorded; proceeds from the sale pass to the seller (or sometimes arrangements are made for proceeds to be disbursed shortly thereafter); a properly executed mortgage instrument is delivered to the lender and is recorded; and the presiding closing agent assumes responsibility for the disbursement of funds to appropriate reserve or escrow accounts and to the appropriate service providers. It is usually not until closing is completed that payment for performance of these services is made.

The Post-Closing Process

By necessity, recordings, disbursements, and delivery of necessary documents occur after the actual settlement process, but these activities are considered an essential part of origination. Following settlement, however, another set of responsibilities is required of the mortgage lender. These include provisions for loan servicing, and when necessary, the sale or marketing of the closed loan in the secondary market.

Servicing

Much of the process of servicing loans involves record keeping. The new loan must be set up on the accounting books, the amount of the monthly payment determined, and the escrow account established. Payments must be recorded when received, and funds must be allocated to escrow and interest and principal reduction. Taxes and insurance must be paid when due, and insurance coverage must be monitored. Accounting must be made to the outside investor or internally for loans kept in the lender's own portfolio. Statements must be rendered to the borrower on interest paid and remaining principal balance, and the escrow account must be analyzed periodically and a new payment amount established to cover any increases in taxes and insurance.

Beyond accounting, special effort is expended for loans that become delinquent or go into default. Collection efforts must be made on delinquent loans. Personal contact and counseling are usually extended to chronically or seriously delinquent borrowers. Loans may be recast or special payment schedules established to cure delinquencies and, when necessary, foreclosure must be pursued for defaulted loans and the property managed and sold. The task of servicing must continue right up to the point when the last funds are recovered either because the loan is paid off and release given to the borrower or because the foreclosed property has been disposed of.

Marketing

Any loans sold by the orginator to other investors require additional effort. Usually, investor commitments for future purchase of loans are obtained before loans are closed. Therefore, loan documentation must be submitted and reimbursement received from the investor; the mortgage must be assigned to the investor, and additional steps are usually added to the servicing process. These steps include monthly accounting of loan payments and remission of appropriate funds to the investor, submission on delinquent and foreclosed loans, and special audits of servicing records and escrow accounts.

It is appropriate to reemphasize the two components of analyzing the lending process: (1) the mechanical preparation of documents and accounting for funds, and (2) the evaluation of risk and its control or limitation. The first involves processing costs that do not directly affect the cost associated with risk of loss, whereas the second is directly related to the risk of loss. It is the evaluation of risk and its control or limitation that affects much of the lending process. In the case of FHA-insured and VA-guaranteed loans, most of the risk of loss is shifted from the lender to a government agency; in conventional lending, the risk is borne by the lender or private mortgage insuror.

Most lenders are under constraint to hold down the level of risk. Therefore, it is the second aspect of the lending process that is of major importance for the financial soundness of the lender. Lenders need to collect and process sufficient information about the borrower and the property to evaluate the risk and then adopt procedures that will limit the overall risk. All of this must be done within the context of an increasing number and greater complexity of laws and regulations that add expense and sometimes make it very difficult for lenders to achieve their objectives.

Exhibit III-3 provides a listing of the reports necessary to close a conventional mortgage loan. It is interesting to note that of the 18 reports, half are mandated by law and three were heavily influenced by laws or regulations.

Use of In-House Personnel

In making arrangements for necessary settlement services, lenders are allowed some discretion in either having members of their own staff perform those services, or in contracting the services out to other parties. Often this practice is entirely an economic one, and specialized service providers will be used only if the institution originates enough loans to support that full-time expense. However, the practice of using in-house staff to perform different services does differ somewhat by type of institution, type of service, and to a limited extent, geographic area.

Less than 2 percent of the respondents to our questionnaire had properties surveyed by their own staff. However, 47.6 percent of the commercial banks responding indicated that they used their own staff to perform credit investigations, as did more than half of the savings banks questioned. More than 40 percent of the respondents use their own staff to prepare at least some of the legal documents. There was little variation in this practice by type of institution, but it was a more frequent practice in St. Louis, Denver, Los Angeles and Seattle than in the other four sites.

EXHIBIT III-3

TYPICAL SET OF REPORTS FOR A CONVENTIONAL MORTGAGE

Conventional single-family mortgage with no insurance, no guarantees, for lenders' own portfolio with no complexities such as qualifying for sale to FNMA or FHLMC.

MORTGAGE CLOSING REPORTS

REPORT	Pages	Lines Or Items	Copies	Mandated By Law	Influenced By Law
1. Notice to Applicants	1	27	3	X	
2. Underwriting Standards	8	320	3	X	
3. Loan Application	2	216	2		X
4. Insurance Information	1	3	1		
5. Good Faith Estimate of Closing Costs	1	27	3	X	
6. Buyer's Disclosure of Real Party in Interest	1	9	3	X	
7. RESPA Docket	1	28	3	X	
8. Notice of Right of Recission	1	32	3	X	
9. Credit Report	1	54	3		X
10. Appraisal Form	1	398	2		X
11. Information on Lawyers	1	46	2		
12. Loan Disbursement Record	1	80	2		
13. Regulation Z, Truth in Lending	1	58	3	X	
14. HUD Settlement Statement	1	24	3	X	
15. Loan Check Requisition	1	14	2		
16. Note	1	41	3		
17. Mortgage	4	118	3		
18. HUD Guide for Home Buyers	31	1,953	2	X	

Source: Savings & Loan News, November 1978, p. 100.

Title searches were performed by staff members of only about one percent of the lending institutions questioned. This does not take into account the frequency with which affiliated title companies perform such services. Appraisals, however, were performed by staff for more than half of the S&Ls and savings banks, for about 26 percent of the commercial banks, but for only one of the mortgage bankers interviewed. These varying practices suggest that the decision to use in-house staff is based less upon custom or competitive practices within a geograpic area than upon an institution's own operational economies.

MORTGAGE FINANCING PROVIDERS

The mortgage financing component of the settlement service package is provided by a broader range of institutions than any other service provider group. These institutions are also more closely regulated than any of the other provider industries, and they are as bound in as much by tradition and conservatism as either the title insurers or the attorneys who provide other essential services. The mortgage financiers can be classified into three broad groups that are differentiated by their source of loanable funds. These include: (1) depository institutions, encompassing commercial banks and thrift institutions; (2) mortgage banking companies; and (3) other institutions, including life insurance companies, corporations, individuals, and other holders such as agencies, trusts pension funds, state housing finance agencies and REITs.

The four institutions most active in the origination or primary lending process are discussed here. In their order of activity level, and in the order that they will be described, these include savings and loan associations, commercial banks, mortgage bankers, and mutual savings banks. Appendix C contains sources for figures referenced in this section as well as a description of the lending and secondary market activity, asset and liability structure, and profitability of these financial institutions.

Savings And Loan Associations

The savings and loan industry of today, including both state and federally chartered institutions, has evolved from the building and loan associations that were established during the early 1800s. These institutions were established both to encourage thrift and savings, and to encourage and provide financing for the construction and purchase of homes.

Today these institutions represent the single largest holder or investor in residential mortgages, as well as the largest originator of such loans. As such, savings and loan associations maintain a direct and well-defined relationship with the consumer, who represents both depositor and loan customer. These thrift institutions have traditionally been a stable source of conventional residential mortgage investment funds. At the end of 1978, nearly 83 percent of the aggregate assets of these associations were invested in mortgages, and over 93 percent of these assets represented conventional mortgage loans. Proportions such as these have undergone little change during the recent history of S&L lending.

Recently, however, these thrift institutions have experienced a transition that is having a substantial impact upon the cost of mortgage money borne by consumers. Savings and loan associations must maintain a positive spread between their average cost of deposits and the average yield that they can earn on their mortgage portfolio and other miscellaneous loans or investments. The average cost of these deposits has been increasing significantly due to increases in the yields provided by alternative investment vehicles, which drives up the costs S&Ls must pay in order to attract deposits.

A gradual easing of Regulation Q requirements will allow S&Ls to become more competitive in offering returns that will attract investors, and their ability to offer money market certificates at interest rates that are tied to Treasury security market yields has allowed them to retain deposits that might otherwise have been withdrawn. However, the vulnerability of these institutions to competitive pressure to maintain and attract deposits has significantly increased marginal borrowing costs, and has placed great pressure on them to improve the yield on their mortgage portfolio by requiring higher mortgage rates.

At the end of 1978 4,723 S&Ls were located throughout the states, the District of Columbia, Puerto Rico, and Guam with an average asset size of about $110 million. These institutions are divided into two charter types: federal and state. Federal associations are chartered by the Federal Home Loan Bank Board (FHLBB), the federal agency that regulates the associations it charters. State associations are chartered and regulated by individual states. In 1978, there were exactly 2,000 federally chartered and 2,723 state chartered S&Ls. In recent years, the number of individual federal and state chartered S&Ls has declined, mainly because of mergers. State chartered S&Ls have shown the largest decline--dropping from 4,466 in 1950 to the present 2,723. Federally chartered S&Ls have decreased from a peak of 2,071 in 1969 to their present total of 2,000.

S&Ls can also be classified according to the insurance status on their savings deposits. All federal associations and 2,053 state associations are insured by the Federal Savings and Loan Insurance Corporation (FSLIC), an instrumentality of the Federal Government. The FSLIC, which is governed by the FHLBB, insures all savings deposits of these S&Ls up to $100,000. It also performs examinations to ensure compliance with regulations that protect savers and borrowers. FSLIC-insured associations held 98 percent of S&L assets in 1978.

Of the 670 non-FSLIC-insured state associations, 403 are insured by state funds. These funds are located in Massachusetts, Ohio, Maryland, and North Carolina and provide insurance on savings accounts in the institutions chartered in these states. The remaining 267 associations have no insurance on savings deposits.

S&Ls are owned either by their members (mutuals) or by the holders of capital stock issued by the association (stock). The depositors and borrowers who own mutual associations are entitled to a voice in the affairs of the S&L.

Stock S&Ls are controlled by the owners of their capital stock and have an advantage over mutuals in that they can expand their net worth by issuing additional stock, whereas mutuals must rely mainly on after-tax income. This difference is important during periods of strong savings growth, as FSLIC-insured savings and loans must maintain minimum net worth levels presented by that agency.

In December 1978, there were 771 capital stock S&Ls, with assets of $127.0 billion, or 24.3 percent of total S&L assets. Of this total of stock S&L assets, 48.7 percent were in California associations.

Commercial Banks

Commercial banks have been in existence since colonial times and are the largest group of financial intermediaries in the country. They have the broadest range of investment capabilities of any financial institution. Like other intermediaries, banks make their profits from the spread between the cost of attracting deposits and the income received from making loans and investments. In addition to being institutions that encourage thrift, banks hold demand deposits--the major component of the narrowly defined basic money supply (M1). Unlike other depository financial intermediaries, the majority of the commercial banking industry's business is not involved in residential mortgage lending--which accounted for only 10.6 percent of assets at the end of 1978. Because of their size--$1.2 trillion in assets--commercial banks, as compared with other lenders, are large residential non-farm mortgage lenders; they accounted for 23.4 percent of all 1978 single-family residential mortgage originations. Total mortgage lending by banks, including commercial and farm loans, amounted to 26.7 percent of all 1978 mortgage originations.

Commercial banks lend and invest their funds in a wide variety of areas by acquiring deposit liabilities in the form of demand deposits (checking accounts), time deposits, savings deposits, and borrowed funds and by issuing subordinated notes and debentures. With all these sources, banks have access to the broadest range of funds of any financial intermediary. Unlike S&Ls and mutual savings banks, commercial banks have a broadly defined lending portfolio which includes consumer loans to individuals, loans to financial institutions, commercial and industrial loans, agricultural loans, loans to security dealers, and real estate loans. In addition, larger commercial banks also invest and trade in government and corporate securities.

All commercial banks are stock corporations, operating according to the broad directives of the voting stockholders. They operate in every state, the District of Columbia, and all U.S. possessions. Unlike S&Ls and mutual savings banks, commercial banks have been increasing in number. At the end of 1978, there were 14,730 commercial banks in the United States. Total assets amounted to $1.2 trillion, with average assets per bank of $88.5 million. The size of commercial banks and the services provided vary greatly.

Like S&Ls, banks are chartered by either the Federal Government (national banks) or state government (state banks). As of June 1978 (latest data available), there were 14,381 commercial banks: 4,616 national and 9,765 state.

National banks, chartered by the Comptroller of the Currency, held 55.2 percent of all June 1978 bank assets. Therefore, even though national banks constituted less than one-third of the total number of banks, they accounted for the majority of the assets.

All national banks are members of the Federal Reserve System, the nation's central banking system. In addition, 1,005 state banks are Federal Reserve members. The Federal Reserve regulates and supervises these banks, and sets minimum reserve requirements and rates at which member banks may borrow funds from it. All non-member state banks are regulated and supervised by state banking agencies located in the states where they were chartered.

In addition to being members of the Federal Reserve System, banks can be insured by the Federal Deposit Insurance Corporation (FDIC). The FDIC insures bank deposits from loss, much as the FSLIC insures savings deposits at S&Ls. In June 1978, there were only 317 non-FDIC state-insured banks holding less than 4 percent of total bank assets.

The commercial banking business is thus highly regulated as a result of: Federal Reserve membership, deposit insurance by the FDIC, chartering by the Comptroller of the Currency, and examination and supervision of state banks by state regulatory agencies. In fact, commercial banks are probably more highly regulated than any other financial institution. Therefore, even though banks are very diverse with respect to their ability to attract funds and make loans and investments, their operations are rigidly controlled and examined. This, of course, does not mean that banks do not fail, make unsound investments, or have inefficient operations.

Mortgage Banking Companies

Mortgage banking activity in the United States dates back to the period after the Civil War, when developing agricultural areas in the Midwest needed additional financing and investors in the East were seeking profitable investments. Because of the travel distance and time involved in communication, as well as the parochial character of real estate transactions, the investors from the East needed to have local representatives on the scene to handle the transactions and represent their interests. As the country became more urban, mortgage banking activity developed in the cities.

The mortgage banking industry has grown from this beginning to the point where in 1978 they were the third largest group of mortgage loan originators in the United States. According to HUD data, mortgage bankers originated $31.3 billion in mortgages in 1978, or 12.8 percent of the total; of this, $28.6 million were in single-family mortgages.

The mortgage banking function is that of an intermediary bringing together real estate purchasers' demands for mortgage financing with investors' supplies of funds available for acquisition of mortgages. As an intermediary, the mortgage banker satisfies the needs of both the borrower and the lender. The need for this intermediary function is reinforced by the difference among regions, that is, among areas with a capital shortage and those with a capital surplus, in mortgage lending funds. The operation of the mortgage banker, therefore, basically consists or originating loans in capital shortage areas and selling to investors in capital surplus areas in order to arbitrate the yield difference and to develop a servicing portfolio.

The four basic functions performed by a mortgage banker include: (1) origination; (2) warehousing; (3) marketing or sales; and (4) servicing. The traditional depository lender will do no warehousing, and will not be organized around the marketing or servicing functions as much as is the mortgage banker. Most mortgage bankers also do construction lending, financing of land acquisition and development, and participate in other related activities such as property management, the sale of property insurance, and other activities related to real estate and financial services.

Mortgage banking firms perform more functions than do most mortgage lending institutions that retain closed loans in their own portfolios. Portfolio lenders do not traditionally warehouse or market residential loans in the secondary market. Not only do mortgage bankers warehouse and market loans in the secondary market, but they may also be required to follow stricter origination and servicing standards than portfolio lenders. For loan originations, these requirements may include specifications about the mortgage (sales price, mortgage amount, loan-to-value ratio), property characteristics (age, style, location), and documentation required (appraisal, survey, title insurance, income verification). Loan servicing requirements may include specifications for reports, collection efforts, and management of the foreclosure process.

Mutual Savings Banks

Mutual savings banks (MSBs) were first established in 1819. Their purpose was to: accept deposits (savings) and allow withdrawals of deposits; invest funds safely; use profits to cover expenses and add to reserves; and make dividend payments to depositors. Like S&Ls, MSBs are thrift institutions that encourage savings and act as financial intermediaries in making investments and extending loans to qualified borrowers.

MSBs have not grown as rapidly as S&Ls, commercial banks, or life insurance companies since the end of World War II. They are, however, the fourth largest provider of residential mortgage funds of the five financial institutions described in this chapter. In 1978, MSBs originated $12.7 billion, or 5.2 percent of the $243.9 billion in mortgages created in the United States. Single-family mortgage originations in 1978 amounted to $9.5 billion, or 5.3 percent of the total. Mortgage holdings constituted 60.2 percent of all MSB assets as of year-end 1978--down from 73.4 percent in 1970 because of increased investment in corporate, state, and local securities, and in non-mortgage loans.

As thrift-oriented financial intermediaries, MSBs encourage savings by offering interest-bearing savings accounts through which individuals and institutions can invest their savings. With these savings deposits, MSBs make investments and loans in a fairly wide variety of areas--including mortgages, U.S. Government securities, state and local government securities, corporate securities, and other non-mortgage loan areas. MSBs are all private institutions, individually controlled by a local board of trustees who make the major decisions concerning operations. Unlike S&Ls, commercial banks, mortgage bankers, and life insurance companies, MSBs are located in only 17 states, and are concentrated in the Northeast. There were 465 MSBs at the end of 1978, with average assets of $340.2 million. Over 70 percent of these MSBs were located in Massachusetts, New York, and Connecticut.

The number of MSBs in this country decreased from 637 in 1910, to 540 in 1940, and 494 in 1970. There are no stock MSBs; MSBs are therefore controlled by their members and their board of trustees, who have a purely fiduciary role. The state in which an MSB is domiciled provides its charter and regulates and supervises its activity. Allowable investments, services, and operating practices thus vary somewhat from state to state.

MORTGAGE MARKET MECHANISMS

The role of the mortgage lender as a provider of financial services is a relatively passive one. Although some institutions may employ direct advertising campaigns aimed at attracting mortgagors, it is most unusual for the lender to directly contact the potential home buyer. Earlier it was shown that most lenders believe that business is successfully developed through contact with builders and real estate agents. It is only in the exceptional case that the home buyer does not initiate contact with the lender to discuss the terms of available financing.

As a result, the selection of a lender by the borrower is typically based upon referrals or upon the reputation or prominence of the lending institution within the local area. From the borrower's perspective, however, alternative lending institutions can be substituted, and the decision made by the borrower is typically based upon the ability of the lender to offer the "best" lending terms, or to meet those "terms" that the borrower feels are the best available. In contrast to other settlement services, the lender is often selected directly by the borrower, and the elements of reverse competition are less pronounced for this settlement service than for mortgage and title insurance.

Later in this chapter, a more detailed discussion will be presented of the factors influencing a borrower's decision to select a particular lender. Most often, however, the most important factor is the mortgage interest rate.

Fees, Points and Yields

Occasionally in very tight money situations, some builders or sellers are able to offer financing at mortgage rates that may be as much as one or two full percentage points below current mortgage financing rates. Sometimes this may be the result of government subsidy programs (such as Brooks-Cranston funding or mortgage money made available through the sale of tax-exempt revenue bonds), but on other occasions, the provision of below market interest rates is accomplished through the payment of points or fees that may either directly or indirectly be passed on to the borrower. It is therefore important to understand the relationship between these points or fees and mortgage rates.

It is a common practice for most lenders to charge a borrower a fee for providing mortgage financing. Sometimes this may be called a "loan fee" or an "administration fee," and it may be payable at the time of application. Other lenders call this an "origination fee," and charge the borrower this amount upon his formal acceptance of the commitment issued by the lender. In many cases, this "fee" is equal to one percent of the loan amount, although some lenders may charge a flat administration fee.

In theory, these fees are assessed borrowers to cover the administrative expenses associated with the application and evaluation process. They also are used to cover the time and expenses that are used to process loans that are either declined by the lender or are refused by the borrower. In any event, they represent income to the lender that may not be related to the yield that a particular loan will provide.

"Points" represent a very different type of charge that a lender may assess either the buyer or the seller or both. A "point" represents one percent of the principal amount of a loan, and as such, administrative or origination fees are often in an amount equal to one point. A point, however, is a discount point or a one time charge that is assessed the lender at closing to increase the yield on a mortgage loan. In that it is the "yield" and not the mortgage rate that is the major objective of both portfolio lenders and mortgage investors, points become a very important determinant of competitive market conditions. To the extent that they are charged borrowers and/or sellers, they may conceal the relative attractiveness of a simple, stated mortgage rate.

Commitments are often issued by mortgage investors in the form of a required yield, or the gross return on investment that the investor will receive over the life of the loan. Most loans for residential properties are 25-30 year loans, but for purposes of pricing mortgage investments, it is traditionally assumed that the morgagor will prepay the loan after 12 years or less. If a lender has a commitment from a buyer to purchase a mortgage at a 12 percent yield (or coupon), it will result in a purchase price of the mortgage of less than par, or less than 100 cents on the full dollar. When this is the case, the mortgage is sold at a discounted price.

If a lender originates a mortgage with an 11 percent coupon for delivery against a commitment requiring a 12 percent yield, the lender can expect the investor to pay a price equal to 93.84 percent of the principal balance of the loan.[1] That is, if the lender has committed $50,000 in mortgage financing to a borrower, he can sell that $50,000 mortgage for only a price of $46,920. The difference of $3,080 will either be a net loss to the mortgage lender, or it can be made up for by points that are charged either the borrower and the seller of the property or both.

Often a primary mortgage lender may originate a loan at a loss; that is, the number of points he may be able to charge at settlement may be inadequate to make up for the loss that he will incur in marketing the loan to a secondary market investor. In the example presented, this would result if the lender were unable to charge the buyer and seller seven combined points. However, mortgage bankers and certain primary lenders may be willing to originate loans at a small loss because of the value that they place upon the servicing income that can be derived from an outstanding loan.

Servicing Fees

Servicing was described earlier in the section on Post-Closing Process, and it includes a number of responsibilities that the servicer must perform in order to keep the mortgagor current in his repayment of the loan obligation. The process consists of accounting and bookkeeping procedures, as well as escrow responsibilities and maintaining insurance and tax payments current, following up on delinquent borrowers, and assisting the mortgagee in foreclosure proceedings.

In exchange for fulfilling these responsibilities, the mortgage investor will typically pay the servicer or loan originator a fee based upon the outstanding principal amount of the loan. Typically this annual servicing fee is three-eights of a percent of the loan's outstanding principal balance, although it does represent a point of negotiation between the mortgage investor and the seller or originator. The fee is paid monthly to the servicer. Only the net amount of the mortgagor's monthly payment is sent to the investor; monthly servicing income is retained by the servicer.

Servicing fees represent a very important form of compensation to the mortgage banker, and institutions that service their own portfolio loans are

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[1] The price of $93.84 per $100.000 of principl loan balance is determined by a present value accounting of all anticipated cash flows resulting from the loan. The discount rate is the required yield of 12 percent, or one percent monthly. The cash flows include an annuity of 144 monthly payments (assuming prepayment after 12 years) of principal and interest (PMT), and a final payment equal to the unpaid or unamortized principal balance (BAL) of the loan.

$$93.84 = \sum_{i=1}^{144} PMT\ (1/1.01)^i + BAL\ (1/1.01)^{144}$$

therefore able to obtain a higher investment yield. Major economies of scale can be realized when servicing a large portfolio of loans, and some lenders may be willing to originate loans at a small loss, or may be willing to originate loans at rates that are somewhat below current market rates in order to develop a servicing portfolio and to recognize the deferred income that such servicing represents.

THE REGULATORY ENVIRONMENT

Primary lenders and originators of residential mortgage loans are influenced by a regulatory environment that encompasses a myriad of state and federal pronouncements. Each of these defines a legal responsibility that must be assumed by the mortgage lender, and in terms of time and training of staff, each has added a cost that must either be assumed by the lender or passed on to the consumer. Representatives of nearly each of the state and national lending associations with whom interviews were conducted commented that these compliance costs are almost always passed on to the borrower in one form or another, and these have had a direct impact upon overall closing-related costs.

The focus of this analysis was not to evaluate the relative costs and benefits of regulations influencing mortgage lenders. Few regulatory requirements are implemented and enforced at no cost to government agencies, lenders, or consumers, and all are enacted to provide some desired benefits. The test of their usefulness is, therefore, not so much a function of their actual cost, but rather a determination of their net or residual value.

The purpose of this section is to provide a brief description of the range of regulatory constraints and/or requirements that mortgage lenders are subject to. Four different types of restrictions are presented, and these include: (1) federal statutes; (2) federal regulatory provisions; (3) state regulations; and (4) restraints imposed by secondary market agencies. Appendix D contains a more detailed presentation of a number of statutes and provisions relating to lender regulations.

Federal Statutes

The decade of the 1970s was truly a period during which federal regulation made substantial contributions to areas such as disclosure, consumer safety, and credit availability. During that same period, substantial requirements were made of institutions active in mortgage lending or loan origination to comply with these regulations. Some that have had a major influence upon mortgage lending and as a result, upon settlement, are included in this chronology:

- 1968 - The Fair Housing Act, or Title VIII of the Civil Rights Act of 1968;

  The National Flood Insurance Act;

The Consumer Credit Protection Act, which included the enactment of Truth-in-Lending and the Fair Debt Collection Practices Act;

- 1970 - The Fair Credit Reporting Act;
- 1973 - The Flood Disaster Protection Act;
- 1974 - The Real Estate Settlement Procedures Act;
- 1975 - The Home Mortgage Disclosure Act;
- 1976 - The Equal Credit Opportunity Act; and
- 1977 - The Community Reinvestment Act.

The extent of the impact of these pieces of legislation is summarized in Exhibit III-4. It identifies the preparations that are required of a conventional single-family mortgage lender for closing a loan that is to be included in his own loan portfolio. Additional information is required to conform to FHA-insurance, VA-guarantee, and private mortgage insurance requirements.

From among these different pieces of legislation, RESPA, the Fair Credit Reporting Act and Regulation Z (Truth in Lending) of the Consumer Credit Protection Act have had the greatest impact upon the loan origination process. Lender and lender association groups interviewed as part of our research frequently observed that the mortgage lender was being singled out and given a disproportionate amount of responsibility for correcting abuses relating to a broad range of consumer issues. This may or may not be a correct assessment; the point remains that these specific Federal Statutes do not, in themselves, represent an exhaustive listing of regulations that have added both responsibilities and costs to the residential settlement process.

Federal Regulatory Provisions

In addition to complying with federal statutes, the residential mortgage lender is subject to the scrutiny of a number of federal administrative regulations by such government bodies as: (1) the Controller of the Currency; (2) the Federal Reserve Board; (3) the Federal Home Loan Bank Board (FHLBB); (4) the Federal Deposit Insurance Corporation (FDIC); (5) the Federal Savings and Loan Insurance Corporation (FSLIC); and (6) the Department of Housing and Urban Development (HUD). Administrative regulations by these agencies represent attempts to interpret, define and sometimes implement legislative provisions for which they have enforcement responsibility.

Some of these provisions are of little consequence; others can impact significantly lender practices and discretion. In the aggregate, these represent an additional level of restraint that both (1) limits a lender's ability

EXHIBIT III-4

PREPARATIONS REQUIRED FOR CONVENTIONAL SINGLE-FAMILY MORTGAGES WITHOUT INSURANCE OR GUARANTEES

REPORT	Pages	Lines Or Items	Copies	Mandated By Law	Influenced By Law
1. Notice to Applicants	1	27	3	X	
2. Underwriting Standards	8	320	3	X	
3. Loan Application	2	216	2		X
4. Insurance Information	1	3	1		
5. Good Faith Estimate of Closing Costs	1	27	3	X	
6. Buyer's Disclosure of Real Party in Interest	1	9	3	X	
7. RESPA Docket	1	28	3	X	
8. Notice of Right of Recission	1	32	3	X	
9. Credit Report	1	54	3		X
10. Appraisal Form	1	398	2		X
11. Information on Lawyers	1	46	2		
12. Loan Disbursement Record	1	80	2		
13. Regulation Z, Truth in Lending	1	58	3	X	
14. HUD Settlement Statement	1	24	3	X	
15. Loan Check Requisition	1	14	2		
16. Note	1	41	3		
17. Mortgage	4	118	3		
18. HUD Guide for Home Buyers	31	1,953	2	X	

SOURCE: Savings & Loan News, November 1978, p. 100.

to carry out unsafe or abusive lending practices and (2) increases the need for following formal practices that reduce lender discretion and slow the origination process.

The Fair Housing Regulations and enforcement program adopted by FDIC are illustrative of such responsibilities. These regulations require that insured state, non-member banks: (1) display the Fair Housing Lender poster; (2) observe rules regarding non-discriminatory advertising practices; and (3) keep records on home loans. The advertising rules require that the lender expressly indicate that the institution is an equal housing lender, in a fashion that is appropriate to the advertising and media format utilized.

This and other responsibilities mandate a tremendous record-keeping effort by lenders, who are required to retain information on home loan inquiries and applicants' name, address, race or national origin, sex, marital status and age, as well as information related to the location of the residential property. If the lender has assets of greater than $10 million as of the end of the prior calendar year, he must obtain and retain a variety of other data pertaining to the applicant, the property and the loan request. With regard to the applicant, this information includes his employment history, income, number of dependents, assets and liabilities, monthly debt obligations, and whether or not he is a customer of the lending institution.

Information required of applicants with regard to the property and to the proposed terms of the loan are even more exhaustive. In seeking such information, the lender must disclose to the applicant that it is being sought to enable the FDIC to ensure compliance with the Federal Fair Housing and Equal Credit Opportunity Acts. The lender is required to retain this information for a period of twenty-five months following notification to the applicant of the action taken.

Regulations of this nature impose four types of responsibilities upon mortgage lenders. These include the requirements to collect data, to process it, to retain it, and to educate personnel in correct compliance procedures. All of these activities involve costs, and because this information is required even for applications that have not become originated loans, these costs become an overhead item that are indirectly passed on to borrowers in the form of settlement charges or interest charges.

Other examples of such regulations imposing substantial compliance responsibilities may be found in the rules promulgated by the Federal Reserve Board and HUD incident to the statutes discussed in the preceding section. Among these regulations are:

- Regulation B (12 C.F.R. 202) implementing the provisions of the Equal Credit Opportunity Act;
- Regulation Z (12 C.F.R. 226) implementing the provisions of the Truth in Lending Act;

- Regulation X (24 C.F.R. 3500) implementing the purposes of the Real Estate Settlement Procedures Act;
- Regulation C (12 C.F.R. 203) implementing the Home Mortgage Disclosure Act; and
- Regulations (24 C.F.F. 1909, 1914, and 1925) implementing the National Flood Insurance Program.

The administration/enforcement of many of the regulations promulgated by the Federal Reserve Board is delegated or relegated by adoption to the various federal financial supervisory agencies. Such regulations, however, impose significant costs ultimately reflected substantially in residential real estate settlement costs.

State Regulations

Another major component of the regulatory environment impacting the residential mortgage lender includes the panorama of state regulation that has survived federal preemption. The diversity of that regulation makes it appropriate to compare federal and state legislation in selected areas in order to illustrate the effect such legislation has had upon compliance responsibilities and settlement costs. Some issues that are briefly discussed here include: disclosure, discrimination, usury, mortgage contracts and provisions, remedies available to a mortgagee, and other parameters.

Disclosure

Numerous state acts deal with disclosure in a way similar to that under RESPA. The pervasiveness of such legislation is depicted in the State Law Chart presented in Exhibit III-5 and in comments appearing in Paul Barron's volumes entitled Federal Regulation of Real Estate.[1] The contracts between statutory provisions and selected state statutes and RESPA, which have been taken verbatim from the Barron text, are set forth in Appendix D.

Discrimination

Indicative of the discrimination provisions are the statutory offerings of California, Colorado, Florida, Maryland, Texas, Virginia, Massachusetts, and the District of Columbia. All entail substantial compliance responsibilities and either expressly or inferentially mandate the preparation and retention of substantial reports and records. It should be noted, however, that

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[1] Paul Barron, Federal Regulation of Real Estate - The Real Estate Settlement Procedures Act - A Practical Guide with Forms (Boston: Warren, Durham & Lamont, 1975).

EXHIBIT III-5

STATE LAW CHART

STATE	CONSUMER PROTECTION	DISCLOSURE	KICKBACK/ UNEARNED FEE PROHIBITION	DESIGNATION OF TITLE INSURANCE COMPANY	DESIGNATION OF SETTLEMENT SERVICES PROVIDER	LIMITATION ON ESCROWS	INTEREST ON ESCROWS
Alabama	X		X				
Alaska			X				
Arizona	X		X	X			
Arkansas			X				
California			X			X	X
Colorado		X	X			X	
Connecticut		X					X
Delaware	X		X	X			
District of Columbia							
Florida			X	X		X	
Georgia			X		X		
Hawaii		X	X				
Idaho	X	X	X		X	X	
Illinois			X			X	
Indiana		X					
Iowa		X					
Kansas	X	X				X	
Kentucky	X	X	X	X			
Louisiana	X					X	
Maine	X	X					
Maryland	X			X	X		X
Massachusetts	X	X					X
Michigan							
Minnesota	X						X
Mississippi	X						
Missouri	X						
Montana							
Nebraska			X			X	
Nevada			X				
New Hampshire	X						X
New Jersey			X				
New Mexico				X		X	
New York			X				
North Carolina			X				
North Dakota	X						
Ohio			X				
Oklahoma	X	X					
Oregon			X	X			
Pennsylvania	X	X	X				
Puerto Rico						X	
Rhode Island	X			X	X		
South Carolina	X			X	X		
South Dakota			X				
Tennessee			X				
Texas	X	X					
Utah		X					
Vermont	X						
Virginia			X	X			
Virgin Islands							X
Washington	X		X				
West Virginia	X		X				
Wisconsin	X						
Wyoming	X	X	X				

SOURCE: A Compilation of Federal and State Laws Regulating Consumer Financial Services.
Kenneat Graduate School of Management, Purdue University.

there are considerable differences in the substantive provisions of the representative statutes.

Usury

Similar differences are apparent in the usury statutes of the various states--not only in the imposition of interest ceilings but also, for example, in the legality of imposition and treatment of various loan-related charges. Exhibit III-6 summarizes the residential real estate interest rate ceilings imposed by the statutes of the selected sample states and the District of Columbia.

The summary of other distinctions between provisions of the usury statutes beyond the scope of this study. However, the existence of such distinctions may be illustrated by comparing the statutory treatment of points charged at using.

Mortgage Contracts And Provisions

With respect to the mortgage contract and related provisions, the laws of the selected jurisdictions vary considerably. Illustrative of these conferences are the provisions dealing with such topical concerns as prepayment penalties and "due-on-sale" provisions. Under the federal law, prepayment may be made without penalty unless a penalty clause is expressly set forth in the loan contract. A summary of the contrasting provisions related to prepayment penalties for the sample states is provided in Exhibit III-7.

The trend is to treat such prepayment provisions with disfavor in other than commercial settings. This posture is reflected in the recently adopted rules and mortgage documents of FNMA and represents a change from historic practices of residential lenders who used such penalties as an earnings cushion in the event of unanticipated repayment of the loan prior to maturity.

With respect to "due-on-sale" provisions, whose effect is to allow the mortgage to accelerate the maturity of the loan if the underlying real estate is sold or transferred by the mortgagor, the laws again vary substantially in the selected jurisdictions.

The FHLBB provisions permit federal S&Ls to include "due-on-sale" clauses in their loan contracts and, at the S&L's option, to declare loans immediately due and payable if the borrower sells or transfers the real property securing the loan without consent of the S&L. However, the applicable regulation imposes three limitations on an S&L's option to exercise the "due-on-sale" clause loans made after July 31, 1976. The first limitation precludes an S&L from exercising the "due-on-sale" clause in the following circumstances:

(1) The acceleration provision is triggered by the creation of a lien or other encumbrance inferior to the association's mortgage or deed of trust;

EXHIBIT III-6

RESIDENTIAL REAL ESTATE INTEREST RATE CEILINGS AS IMPOSED BY THE USURY STATUTES OF SELECTED STATES

STATE	PROVISIONS
California	FHA - West's Ann. Calif. Financial Code § 27003-4. (However, the statute creating the FHA is not effective without a constitutional change yet to be made.) General: - Exemptions exist for loans closed by savings banks and building and loan associations, and credit unitions. There is no limit for these loans. West's Ann. Calif. General Law 3757 § 3 (Supp. 1972) Uncod. Meas. 1919-1 to 55.
Colorado	No FHA or VA exceptions. A consumer loan does not include a "loan primarily secured by an interest in land" where the finance charge does not exceed 12 percent, calculated according to the actuarial method on the unpaid balances of the amount financed, assuming the payment terms are met and no prepayment. Where such charges do exceed 12 percent, the full requirements of a consumer credit sale must be met with an 18 percent ceiling on the rate. Colo. Rev. Stats. 1973 § 73-3.105. (However, the UCCC does apply to such loans with regard to disclusure, debtor's remedies, and in the case of an agreement that the loan is subject to the code. Colo. Rev. Stats. 1973 § 73-3.301, -5.201, -3.601). The 12 percent cut-off for real estate transactions was chosen as a convenient line of demaraction between two dissimilar transations--the home mortgage and the high-rate "small loan" type of real estate loan. The exclusion of home mortgages was made because the problems of home financing are sufficiently different to justify separate statutory raatment. The high-rate second mortgage transaction has been a major source of complaint and merits full coverage by the Act. (Official Comment of the National Conference of Commissioners on Uniform State Laws.)
District of Columbia	FHA VA } D.C. Regulation 70-38 (1970). A rate of 10 percent applies on first mortgage and dees of trust on residential realty. A rate of 11.5 percent applies to loans other than a first mortgage on realty. D.C. Code § 28-101.
Florida	FHA VA } Fla. Stats. Ann. § 518.08. General: No limit is imposed on conventional mortgage loans over $100,000. Fla. Stats. Ann. § 687.02
Maryland	FHA VA } Ann. Code of Md. § 49-12 General: 10 percent rate on loans secured by residential mortgage. Ann. Code of Md. § 12-103
Massachusetts	General: 1.5 percent a month is the maximum allowable rate on realty loans of more than $1,500 secured by other than a first mortgage on an owner-occupied dwelling (six or fewer units) where property value is less than $40,000. Gen. Laws of Mas. Ch. 140 § 90A.
Missouri	General: Credit units may land at 1 percent per month. Vernon's Ann. Missouri Stats. § 408.052-1.
Texas	FHA VA } Exemptions General: 10 percent for individual unincorporated business loans: 18 percent for corporate loans over $5,000. "Interim construction loan" may be made at corporate rate to any borrower.
Virginia	FHA VA } Code of Va. 1950 § 6.1-328 General: No limit on first mortgage loans including leaseholds over 25 years: other provisions as listed in the Interest/Usury Chart apply to second loan mortgages. Loans pursuant to FHLMC or VA. H.D.A. are exempt. Code of Va. 1950 § 6.1-328
Washington	FHA VA } for Mutal Savings Banks Rev. Code Wash. Ann. 32.30.040

SOURCE: A Compilation of Federal and State Laws Regulating Consumer-Financial Services, Krannert Graduate School of Management at Purdue University.

EXHIBIT III-7

CONTRASTING CONTRACT PROVISIONS IN SELECTED STATES

JURISDICTION	STATUTORY CITE	DISPOSITION
Florida	FSA § 665.391	Charge may not be greater than 2 percent of amount prepaid.
Texas	Vernon's Ann. State. Art. 852-5-07	Prepayment permitted and not considered as interest on the obligation.
Washington	No Provision	N/A
Missouri	Vernon's Ann. Missouri Stats. § 408.036	No penalty may be imposed when the full principal balance is paid greater than five years after the date of the loan but prior to maturity.
District of Columbia	No Provision	N/A.
Massachusetts	Gen. Laws of Mass. Ch. 170 §24	Borrower may prepay interest no greater than 12 months beyond the taxable year. Cooperative bank may impose a prepayment charge.
	Gen. Laws of Mass. Ch. 168 §36	Upon written request of borrower, interest may be prepayed to a Massachusetts savings bank no greater than 12 months beyond the taxable year with no penalty. Additional prepayments of principal may be made.
	Gen. Laws of Mass. Ch. 172 §55	Prepayment provisions applicable to MSBs, per above, apply to trust companies.
	Gen. Laws of Mass. Ch. 171 §24	Credit unions must accept excess payments of principal.
California	West's Ann. Calif. Civil Code §2954.9	No penalty may be charged unless expressly set forth in the contract. If mortgage property is a single-family dwelling, only prepayment within five years of the making of the loan can be penalized. Prepayment of no more than 20 percent of the original principal amount within any 12-month period may not be penalized. If within a 12-month period a payment of greater than 20 percent of the principal amount is made, a penalty of no greater than six months' advance interest on the excess of the amount which is greater than 20 percent may be imposed.
Colorado	Colo. Rev. Stats. 1973 §11-41-119	Any association may charge for the privilege of prepayment, in part or in full, if the original contract so provides, an amount no greater than 90 days' interest on the amount prepaid.
Maryland	Ann. Code of Maryland Comm. Law. Art §12-103(4)	If included in the contract provisions, a prepayment penalty will be allowed. If the real property securing the loan is a home, combination of home and business property, agricultural property, or if the loan is a commercial loan of less than $5,000, a penalty may be imposed only on prepayments with three years from the date of the loan, and penalty may not exceed an amount equal to two months' advance interest on the aggregate of all the amounts of prepayments made in any 12-month period in excess of one third of the amount of the original loan.
	§12-103(b)iii	There is no prepayment penalty in connection with a loan in which the lender charges interest an effective rate not in excess of 10 percent per annum on the unpaid balance of such loan.
Virginia	Code of Va. 1950 §§6.1-330.27, -.28, -.29	A penalty of no greater than 1 percent of the unpaid principal balance may be charged on a first lien mortgage which is less than $75,000. If it is not a first lien, but the borrower occupies the property, a penalty of no greater than 2 percent may be charge. No penalty may be otherwise charged for a credit union loan. This statute applies to all lenders.
	§6.1-330-33	A lender may not obtain a penalty if prepayment results from the sale of real property which secures the loan.

SOURCE: A Compilation of Federal and State Laws Regulating Consumer-Financial Services, Krannert Graduate School of Management at Purdue University.

best copy available

(2) the creation of a purchase money security interest for household appliances;

(3) the transfer by decree, descent, or by operation of the law upon the death of a joint tenant; or

(4) the grant of a leasehold interest of three years or less not containing an option to purchase.

The second limitation enables federal S&Ls to waive the option if, prior to the sale and transfer of the property securing the loan, the S&L and the person to whom the property is being sold or transferred agree in writing that such person is credit worthy. Finally, the third limitation precludes a federal savings and loan from imposing a prepayment penalty or equivalent charge on the borrower where the lender has exercised his option to accelerate the loan (12 C.F.R. 545.6-11(f&g)).

Turning to the state laws on "due-on-sale" provisions, we find that three of the sample states have specific statutory provisions dealing with such clauses; the rest of the states have dealt with the reasonability of such clauses as a contractual matter on a case-by-case basis.

First and most comprehensive of the provisions dealing with "due-on-sale" clauses are those in California. The California Act, applying to loans executed or refinanced after January 1, 1976, prohibits such acceleration when the transfer:

(1) goes to the co-obligator spouse of a decedent transferee;

(2) is to a spouse who becomes co-owner on the tranferee's death;

(3) results from a divorce, legal separation, or property settlement, and the obligator by the terms thereof is required to continue to make payments;

(4) is an intervivos trust in which the obligators are beneficiaries; or

(5) results from a junior encumbrance or lien on the property or a portion thereof, and the property contains one to four units of housing.

The California Courts have also shared in the task of establishing parameters for "due-on-sale" clauses. It is apparent that the enforceability must be determined in that State on a case-by-case basis, in view of the California Supreme Court's willingness to view some "due-on-sale" provisions as an unreasonable restraint on alientation and therefore unenforceable (e.g., Tucker v. Lassen Savings & Loan Association, 12 Cal. 3d 629 (1974)).

Another state that has taken a prohibitive posture with respect to such clauses is Colorado. The Colorado statute (Colo. Rev. Stats. 1973 Section 38-30-165), which applies to conventional mortgages made after July 1, 1975, secured by residential real property other than hotels, motels, and nursing homes, prohibits:

(1) acceleration other than in circumstances where the transferee is determined to be financially incapable of repaying the debt by its terms;

(2) charging or collecting a fee of greater than 0.5 percent in the event of such transfer; or

(3) increasing the interest rate more than 1 percent per annum or other modification of terms in favor of the mortgagee and, in circumstances where the transferee refuses to accept the modification in the interest rate, he is entitled to prepay the debt without penalty or increase in the interest rate at any time within 60 days of the notice. After 60 days he is obligated to pay interest at the increased rate subject to the 1 percent limitation.

A third state with statutes regarding "due-on-sale" provisions is Virginia. The Virginia statute (Code of Virginia 1950 Section 6.1-330-34) provides that any "due-on-sale" or conveyance provision must be stated in the mortgage contract, and that no payment penalty may be collected from either the tranferor or the transferee in the event of a conveyance triggering the "due-on-sale" provision of a mortgage contract.

The above three state law examples (Virginia, California, and Colorado) and the rule promulgated by the FHLBB are indicative of the considerable variance in treatment of "due-on-sale" provisions. Such provisions and the underlying "due-on-sale" clauses are important since they materially affect the average term of the loan; for that reason, they have a significant bearing on both yield and settlement costs when interest on the residential real estate mortgage is constrained by statutorily imposed usury ceilings.

Remedies Of The Mortgagee

Another component of regulations illustrating the state statutory impact on residential real estate settlement costs is remedies available to the mortgagee. The impact is due to the fact that lenders--despite almost universal provisions making the borrower liable for costs incurred in the event of default--build a portion of the anticipated costs of exercising available remedies and defaults into both the interest rates and settlement costs of virtually every mortgage in their portfolio.

The remedies available in the sample states differ significantly. It is possible, however, to compare meaningfully at least three components of the remedial package--the power of the sale, the right of redemption, and the availability of a deficiency judgment--to illustrate their differences. Such a comparison is provided in Exhibit III-8.

Other Constraints

The last component discussed here of state regulations affecting residential real estate settlement costs is the myriad of portfolio and other constraints placed on state regulated and/or chartered entities such as insurance companies. An example of such constraints is the portfolio parameters placed on insurance companies as regards mortgage loans and, more specifically, factors pertinent to the settlement cost--such as the loan-to-value ratio and related restrictions. Examples of these constraints upon the investment discretion given life insurance companies in some states are shown in Exhibit III-9.

Other such constraints affecting the residential real estate settlement costs incurred by borrowers and lenders are far too numerous to list and distinguish. It should be noted, however, that such limitations are both numerous and significant as regards compliance responsibilities and, ultimately, costs.

The various components selected are indicative of the fact that state regulations--statutory and administrative--impose on the residential real estate mortgage lender substantial compliance responsibilities and consequent costs. Moreover, they illustrate the myriad of state and federal regulations facing the lender, and the considerable redundancies in the regulatory process as a whole.

Secondary Market Agency Restrictions

A consideration of regulatory constraints upon the activities of mortgage lenders would be incomplete without at least some reference to the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA). Each of these institutions is designed to provide liquidity to the national mortgage market by issuing commitments to purchase whole loans that conform to particular standards with regard to credit, underwriting and appraisal standards. Because of the tremendous volume of loans that these institutions purchase, their own standards with regard to requirements for down payments, title and mortgage insurance, have been adopted by many other secondary market investors from the private sector.

Both FNMA and FHLMC serve principally a single lender group. More than 80 percent of FNMA purchases during 1979 were delivered by mortgage bankers, and in that same year, savings and loans delivered more than 75 percent of the mortgages purchased by the Mortgage Corporation. FNMA purchases FHA, VA and conventional loans, but deliveries to the Mortgage Corporation are primarily conventional loans.

The GNMA securities market represents a third "agency-related" secondary market participant. FHA and VA loans conforming to particular standards are

EXHIBIT III-8

COMPARISON OF THREE MORTGAGEE REMEDIES IN SELECTED STATES

JURISDICTION	POWER OF SALE	RIGHT OF REDEMPTION	DEFICIENCY JUDGMENT
California	Power of sale exists facilitated by the fact that lenders employ deed of trust forms almost exclusively in preference to mortgages.	No right of redemption exists after sale of property under deed of trust. Under mortgage foreclosure there is a one-year right of redemption and purchaser is entitled to possession and rents. Calif. Civil Procedure Code §700.	Deficiency judgment is not obtainable except in circumstances other than a purchase money mortgage. After the foreclosure action a deficiency may be had for not more than the amount by which the entire indebtedness due at the time of sale exceeds the fair market value of the property as determined by the court pursuant to an impartial appraisal, but such judgment may not exceed the difference between the amount at which the property was sold and the entire amount of the debt. Calif. Civil Procedure Code §726, 580a.
Colorado	Power of sale exists in favor of	Redemption right in agricultural land exists for six months, such land being retained as described by measured bounds as opposed to a subdivision description. Colo. Rev. Stats. 1963 §38-39–102(2). The redemption right in non-agricultural property is 70 days. Colo. Rev. Stats. 1973 §38-39-102(1).	A deficiency judgment may be obtained.
District of Columbia	Power of sale subject to provisions that the terms of the same and notice are to be given by the holder of the land secured by the deed of trust or mortgage by written notice to the owner of real property encumbered by such deed of trust or mortgage with a copy to the District of Columbia Commissioner in such form as Commissioner may prescribe at least 30 days in advance of the sale.	No redemption right exists after the sale.	A deficiency judgment may be obtained.
Florida	Right of sale by judicial sale in accordance with the provisions of FSA §702.01, - .02.	No redemption right after the sale. Alternatively a 60-day appeal period exists from date of decree effecting sale.	A deficiency judgment may be obtained in accordance with the provisions of FSA §703.06.
Maryland	Power of sale exists subject to special exception in Baltimore where sale requires decree of equity court.	No right of redemption after sale.	Deficiency judgment may be obtained provided motion therefore is made within three years of the date of the ratification of the creditor's amount.
Massachusetts	Power of sale pursuant to Gen. Laws of Mass. Chap. 244 §§11-18,36. In addition to publication of the sale, a notice of foreclosure must be mailed to the mortgagor or his successor by registered mail. Gen. Laws of Mass. Chap 244 §14.	No right of redemption after sale.	Deficiency judgment may be obtained.
Texas	Power of sale exists.	Redemption is not allowed after sale.	Deficiency judgment may be obtained.
Virginia	Power of sale exists subject to provision that secured party or trustee shall given notice of the proposed sale to the present owner. Failure to do so, however, will not affect the validity of the sale. Code of Va. 1950 §55-59.	No redemption right exists after the sale.	Deficiency judgment may be obtained.
Washington	Power of sale by action in Superior Court pursuant to §61.12, 060 for mortgage. Trust deed may be foreclosed by notice of sale in the absence of pending action on obligation security. Time period four to six months.	One year in foreclosure by court action. None after sale by trust deed. Purchaser has right to possession 20 days after the sale and right thereafter to summary proceedings to obtain possession. In foreclosure of land used for farming purposes or a homestead, the judgment debtor may retain possession during the redemption period, although the purchaser on the day of the foreclosure sale is entitled to possession unless premises are in possession of a tenant holding under an unexpired lease, in which case purchaser is entitled to receive rents from the tenant or the value of the usual occupancy thereof during the period of redemption.	Deficiency judgment may be obtained except where right waived and limited circumstances of Chapter 80, 1965 Session Laws of June 6, 1965.

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SOURCE: *A Compilation of Federal and State Laws Regulating Consumer Financial Services*, Krannert Graduate School of Management of Purdue University.

EXHIBIT III-9

LIFE INSURANCE COMPANY INVESTMENTS IN MORTGAGES AND LEASEHOLDS

STATE	PROVISIONS
California	75 percent of unencumbered real property, or such property together with improvements, and also where loan is issued for a building on real property together with actual cost of improvements there. (Deering's Calif. Code, Stats. 1963, c. 1321, sec. 1, amending sect. 1176, Insurance Code.) In loans on security of unencumbered leaseholds, 75 percent, if real property primarily improved by a single-family residence, and the term does not exceed 30 years. If not on real property primarily so improved, term the same, 66-2/3 percent. Where a building loan, 75 percent if real property primarily improved by a single-family resident, on other cases 66-2/3 percent. Fully guaranteed loans under FHA and VA, or partially guaranteed loans under VA, if unguaranteed portion does not exceed 75 percent. (Deering's Calif. Code, Stats. 1963, c. 1321, sec., 2, amending sec. 1192.2, Insurance Code.) FHA loans are authorized (sec. 27002, Financial Code), as are also VA loans (sec. 1176.5, Insurance Code).
Colorado	From 1/1/77 to 12/31/77 inc. 67 percent of admitted assets; from 1/1/78 to 12/31/78, 64 percent; from 1/1/79 and thereafter, 60 percent (L. 1975, sec. 10-3-216). FHA and VA loans are authorized (sec. 10-3-118).
District of Columbia	33-1/3 percent more on amounts loaned by first liens on real estate or 50 percent more than amounts loaned on leaseholds in U.S. or Canada that is unencumbered except by rentals to owner of fee (sec. 35-535, 5a, 5b). Leasehold loan must be fully amortized during unexpired portion of lease. FHA and VA loans authorized (sec. 35-535).
Florida	80 percent in U.S. and Canada as to dwelling primarily intended for occupancy by not more than two families, or 75 percent in case of other real estate mortgages (625.327 (2a)) except purchase money mortgages may not exceed unpaid portion of the purchase price (625.327(4)) . L. 1976, c. 76-168, eff. 7/1/82, repeals sec. 625.327. FHA loans are authorized (sec. 518.06).
Maryland	75 percent in first mortgages or deeds of trust securing unencumbered fee sample or improved leasehold property in the U.S., D.C., or Province in Canada; provided, however, that any amount exceeding 66-2/3 percent of the face market value of such fee sample or leasehold real estate shall not be included in reserve and capital investments, unless such fee simple or leasehold real estate is primarily improved by a residence and such loan provides for annual amortization payments over a period of not over 25 years (Art. 48A, sec. 96(7)). FHA and VA loans are also approved investments under this act.
Massachusetts	75 percent on improved an unencumbered real property in any state of U.S., D.C., Puerto Rico, and Canada (subject to certain restrictions on Canada) and leaseholds for 21 years or more if payments pay off loan in 4/5 of the term unexpired when loan is made (C. 175, sec. 63, as amended by L. 1960, S.B. 229, app. and eff. April 7, 1960).
Missouri	75 percent upon unencumbered real estate in U.S. or territory thereof or unencumbered leaseholds having at least 25 years of unexpired term (376.300(1)(9) as amended by L. 1973, p. 492). FHA and VA loans are authorized under this section.
Texas	For first liens on real estate, one-third more than amount loaned, and on leaseholds on real estate and improvements thereon but term of loan may not exceed 4/5 of the then unexpired term of leasehold which must extend 10 years beyond term of loan with loan payalbe only in equal monthly, quarterly, semi-annual, or annual installments on principal or principal and interest during a period no exceeding 4/5 of unexpired term of leasehold. FHA and VA loans are authorized (Ins. Code, Art. 3.39, as amended L. 1961).
Virginia	75 percent (real property primarily improved by a single-family residence shall provide for amortization of principal payments annually or more frequently over a period of not more than 30 years, Chap. 266, Va. Laws, 1966) - on improved and unencumbered real property in U.S. and Canada. On leaseholds on improved and unencumbered real estate in U.S. if at least 30 years of the term has not expired and not in excess of appraisement in writing of the fair makret value by at least two competent appraisers (Chap. 266, Va. Laws, 1966). However, each of these percentages to value may be exceeded in FHA and VA loans to the extent payment of indebtedness is guaranteed by FHA or VA (sec. 38.1-207).
Washington	An insurer may invest bonds or evidence of debt which are secured by first mortgages on improved real property in U.S., mortgages insured by VA or FHA and evidences of debt secured by first mortgage upon leaseholds running for a term of not less than 13 years beyond maturity. Investments shall not exceed 75 percent of fair value of particular property at time of investment (L. 1969, ch. 241, eff. 8/11/69, amending RCW 48.13.110, 48.13.120).

SOURCE: Mortgage Real Estate Guide, 1979 Edition, Malcombs Sherman

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eligible for combining into pools of loans that are registered with the Government National Mortgage Association. Securities backed by these pools of mortgages are sold to securities dealers, who maintain a highly liquid market in such mortgage-related instruments.

SUMMARY

A review of the regulatory environment impacting the residential mortgage lender suggests the existence or development of several regulatory trends. The first, and most salient of these, is the apparent increasing involvement of the Federal Government in the traditional bastions of state regulation. The enactment of RESPA, as amended, is an example of such a trend.

A second trend emerges when considering the increasing role lenders are required to fulfill in supporting community welfare. Enactment of the Community Reinvestment Act and the Home Mortgage Disclosure Act exemplify the intent to make the real estate lender a vehicle for implementing stated housing and social goals. A third trend suggests a legislative position, at both the federal and state level, that perceives financial institutions in general, and mortgage lenders in particular, as an appropriate vehicle for carrying out new regulations to benefit consumer interests. This trend suggests an overall lack of integration and has had a very direct effect in increasing closing and settlement-related costs.

Finally, a body of quasi-regulatory guidelines is emerging as a result of the mortgage market's increasing dependence upon secondary market institutions such as FNMA, GNMA and FHLMC. These guidelines can be perceived as a positive force, for they have contributed greatly to reconciling interregional differences in mortgage rates. However, these institutions are not maintained without a cost that is eventually borne by the consumer or mortgagor. The legacy of these trends is an increasingly complex, highly regulated, formal, and increasingly costly environment surrounding both the mortgage lender and, more indirectly, the consumer.

IV. THE PRIVATE MORTGAGE INSURANCE INDUSTRY

The private mortgage insurance industry has played an increasingly important role during the past decade in making conventional mortgage financing available to home buyers. During that time, the number of firms within the industry has increased from five to fourteen, and the total amount of insurance in force has increased from $7.3 billion to over $90 billion. Private mortgage insurance has contributed to the development of a stable and liquid secondary market for high loan-to-value ratio (LTVR) conventional loans, and, along with the FHA insurance and the VA guarantee programs, it has provided the means for a large number of young and moderate income households to participate in the equity build-up that has resulted from home ownership during the 1970s.

This chapter presents a detailed background of the role played by mortgage insurance in the conventional home financing process. That role, however, is predominantly an institutional one. The mortgage insurer is conspicuously absent from settlement and has no direct contact with the consumer or home buyer. The need for mortgage insurance is determined by the mortgage lender, and it is he who is instrumental in selecting the insurer. The borrower, however, is in nearly all cases held responsible for payment of insurance premiums, and thereby renders this tripartite relationship a classic example of reverse competition.

To understand the need for mortgage insurance, and the full role played by the insurer in providing mortgage financing, a consideration of the development of the industry is important. The first part of this subsection addresses the background of the industry and illustrates the increasing frequency with which private mortgage insurance has become a part of the real estate settlement process.

Mortgage insurance is a product designed to fulfill the needs of mortgage lenders. As such, it represents a combination of both: (1) a basic, risk-transfer insurance service, and (2) a package of supplementary services designed to assist the mortgage lender in performing his lending function. These features of the mortgage insurance product are described in this section, along with the procedures that make up the insurance delivery process. In this section, a brief description of the pricing structure of the insurance product is provided; this will form a basis for our discussion of the basic competitive issues relating to pricing that appear in Part 2.

The mortgage insurance industry is one of the most homogeneous of the settlement service providers that are considered in this overall evaluation of RESPA. This section describes the basic organizational structure that has been adopted by nearly all firms, and it evaluates the structure of the industry, its financial performance, and the aggregate market share of each of the firms at both the national and state level. A brief profile of each firm's background is also presented here.

The private mortgage insurance industry operates within an atmosphere of strong but indirect regulation. Although specific regulation is a responsibility that is delegated to the state, national performance and operating standards are effectively defined by secondary mortgage market institutions such as the Federal Home Loan Bank Board (FHLBB), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA). This section describes the effects of that regulation, and emphasizes its impact upon primary mortgage lenders of all types.

HISTORICAL PERSPECTIVE

The Early Industry

The practice of insuring individual residential mortgages was first introduced in the United States in 1892 by a group of large, diversified, and multiple-line insurance firms. In that year, New York State's Insurance Law was enacted, which indirectly authorized title insurance corporations to guarantee the repayment of both mortgages and bonds. This authority was clarified 12 years later (1904) when the state passed legislation that clearly gave such companies the power to guarantee repayment of mortgages and bonds. In 1911, further legislation permitted New York title insurers to buy and sell residential mortgages.

The private mortgage insurance industry expanded rapidly during the period of economic growth that followed the First World War. Mortgage insurers were often developed as affiliates of title insurance firms, and New York City became the center for this insurance activity. The industry experienced significant growth during the 1920s; this was due in part to the relative attractiveness of investments in mortgages vis-a-vis investments in high-grade bonds. From 1920 to 1930, total guarantees outstanding by companies guaranteeing and insuring mortgages increased more than five-fold. Exhibit IV-1 demonstrates the growth experienced by the industry in terms of number of firms, capitalization and insurance in force during this period.

The established reserves of these companies did not grow as rapidly as did their liabilities during the 1920s, and the insurance-in-force to capital-plus-reserves ratio increased from 8.8:1 in 1920 to about 14:1 in 1930. The size of the 1930 ratio would not be unusual by present-day standards, but these firms were more financially vulnerable because:

- portfolio investment practices during the late 1920s were highly speculative; and

- most mortgage insurers included in their reserve portfolios investments in mortgages that they had insured themselves.

EXHIBIT IV-1

GROWTH OF THE PRIVATE MORTGAGE INSURANCE INDUSTRY
1920-1930

YEAR	NUMBER OF FIRMS	CAPITAL + RESERVES ($000)	INSURANCE IN FORCE ($000)	ACTUAL LIABILITY ($000)	INSURANCE IN FORCE TO CAPITAL RATIO
1920	11	$ 60,000	$ 528,000	$ 529,000	8.8:1
1930	50	204,000	2,867,000	2,867,000	14.1:1
Percent Change 1920-1930		240%	442%	442%	

Source: Alger Commission report to Governor Herbert Lehman (October 5, 1934).

As a result, the industry was unable to cope with the severe financial strains placed upon it by the early years of the Depression. The financial crash of 1929 resulted in: (1) a severe decline in the value of investment portfolios, and (2) extensive delinquencies, foreclosures, claims and eventually substantial losses to the guarantors. The unregulated investment and insurance practices that were commonplace in the industry exacerbated the extent of the losses. The industry further suffered from its practice of both guaranteeing and investing in the same realty obligations.

During the early 1930s, hundreds of millions of dollars were lost by both institutional and individual investors who had either purchased certificates in pools of mortgages insured by these private mortgage insurance firms, or had deposited funds in banking institutions which invested in such certificates.

In 1934, George Alger was appointed by New York Governor Herbert Lehman to investigate the collapse of the mortgage insurance industry. Alger concluded that private mortgage insurance was a sound and practical financial concept but that regulation was required to prevent bank holding companies and title insurance firms from owning mortgage insurance companies, as this practice had worsened the losses caused by the 1929 crash. Alger completed his report on the management of title and mortgage insurers operating in New York State on October 5, 1934, and submitted it to Governor Lehman. In the report, Alger concluded that:

> The business of guaranteeing mortgages is not an ordinary banking function and the public would have been better served if none of the companies had owned or been affiliated with banking institutions, or in turn had not been owned by them.

Among Alger's specific recommendations were the following:

- Mortgage insurers should be limited to insuring and servicing mortgages.
- No more than 25 percent of any mortgage insurer should be owned by any single person, firm, or corporation.
- No insurer should invest in or own more than 10 percent of the stock of any other company.
- Actual liability for mortgages guaranteed as to principal should not exceed 10 times capital plus surplus.
- Twenty-five percent of capital plus surplus should be invested in state and government bonds or trust funds.
- Servicing charges and insurance premiums should be limited to 0.5 percent of the mortgage principal.
- Guarantees should be provided on no mortgages exceeding two-thirds of a home's appraised value.

Alger's recommendations formed the basis for legislation that led to the development of the private mortgage insurance industry some 23 years later. During the interim, the Federal Government designed and implemented mortgage insurance and guarantee programs to expand the availability of mortgage funds to home borrowers.

Federal Insurance And Guarantee Programs

Federal Government programs, particularly the National Credit Corporation and the Reconstruction Finance Corporation, tried unsuccessfully to salvage the mortgage insurance industry during 1931 and 1932. Following the bank holiday of 1933, all of the mortgage insurers were placed in liquidation. Soon after, the Federal Government took decisive steps to establish a legitimate alternative to the product that had been provided by the private mortgage insurance industry. The need for such action was clear; the government needed to reestablish faith in the mortgage credit markets and to reduce the spectre of uncertainty that had been associated with the collapse of the mortgage guarantee industry. The government also saw such action as compatible with, if not essential to, stimulating the economic recovery of a nation that was nearly at the bottom of a long and severe Depression.

The Federal Housing Authority

The passage of the National Housing Act in 1934 created FHA, the Federal Housing Authority. The purpose of the Act was to effect economic recovery of the residential construction industries by providing lenders and investors in residential mortgages the full faith and credit guarantee of the United States government. FHA was also given responsibility for promoting other needed changes in the national housing markets such as the development and support of low- to moderate-income housing programs.

To achieve these purposes, FHA was given authority to provide insurance guaranteeing the mortgage lender and investor against loss due to the inability of an approved borrower to repay a loan. Such insurance covers 100 percent of the loan amount up to a maximum amount. The amount is currently set at $60,000. FHA also establishes a ceiling mortgage interest rate above which lenders may not charge FHA-insured mortgagors. That ceiling rate tends to move up and down with credit market conditions, but it is generally somewhat lower than prevailing mortgage rates.

To support this insurance program, FHA charges mortgagors an annual insurance fee of 50 basis points or 0.50 percent of the unpaid principal balance (UPB) of the mortgage amount. FHA requires that this insurance be kept in force for the full term of the mortgage, which is typically 30 years. Upon prepayment or full repayment of the loan, the mortgagor may receive a partial return of his insurance premiums.

As part of its goal to stimulate mortgage lending to moderate-income borrowers, the FHA program provided insurance on loans with less restrictive down payment requirements. This represented a substantial departure from earlier residential mortgage lending, which typically required down payments of as much as 25 percent or more of the purchase amount.

The Veterans Administration

Ten years later, the VA loan guarantee program was enacted as a part of the Serviceman's Readjustment Act of 1944. Its purpose was to facilitate home ownership among those who had served in the United States Armed Forces. Eligibility requires a minimum of 90 days of wartime or 180 days of honorable peacetime service. The program guaranteed the lessor of \$12,500 (currently \$25,000) or 60 percent of the mortgage loan amount. Unlike the FHA program, there is no maximum limit on the size of a VA-guaranteed loan. In addition, the VA borrower is not charged any fees that are comparable to the 0.50 percent insurance fee charged the FHA mortgagor. Loans guaranteed under this program are fully assumable (subject to credit approval) when the veteran sells the home to another homebuyer.

Like FHA, the VA program also establishes an interest rate ceiling. With few exceptions, the maximum allowable VA rate has been the same as that set for the FHA single-family home loan program.

The Modern Mortgage Insurance Industry

In 1956, a company that was to become the Mortgage Guaranty Insurance Corporation (MGIC) petitioned the Insurance Commissioner for the State of Wisconsin to permit the insurance of residential mortgages as a legitimate, licensed insurance activity. This was the first attempt by private industry to act upon the recommendations made by George Alger in 1934. The Insurance Commissioner investigated those factors which had led to the massive insolvency of the mortgage insurance industry during the 1930s and concluded that a broad range of conservative financial requirements were necessary to make a private insurance practice viable.

Regulations for such an insurance activity were quickly promulgated. To reduce the likelihood that the industry would repeat the failures experienced in the 1930s, rather strict accounting and investment requirements were mandated. All licensed mortgage insurers were required to maintain a minimum capitalization of \$250,000. To prevent the recurrence of the problems of the 1920s which resulted from firms insuring both the title and mortgage for the same property, mortgage insurers were limited to writing only mortgage insurance and no other type.

Another important new provision limited the insurer to coverage on only 20 to 25 percent of the outstanding loan balance. This regulation deviated significantly from the earlier practice of guaranteeing the entire loan amount. It apportioned risk between the insurer and the lender, and created an incentive for that lender to underwrite insured loans as critically as those without insurance. This practice effectively established an element of coinsurance between lender and insurer, and prevented a lender from shifting full financial liability to the insurer.

Licensed mortgage insurers were also required to set aside 50 percent of all earned premiums into a contingency reserve designed to cover catastrophic losses. Such premiums could not be used for 120 months, after which they could be recognized as taxable income.

MGIC began insuring conventional mortgages in February 1957. Its basic policy insured the 20 top percent of the claim amount, which includes both the unpaid principal and other foreclosure-related costs incurred by the lender. Only loans with a minimum down payment of 10 percent were eligible for such insurance. This basic insurance policy required a first-year premium of 1 percent of the loan amount and subsequent annual renewal premiums of 0.25 percent of the unamortized (or remaining) principal balance.

MGIC maintained a monopoly in the private mortgage insurance industry until 1961 when another Wisconsin firm, Continental Mortgage Insurance, Inc. (which become VEREX Assurance, Inc. in 1977), was licensed and began operation with an initial capital investment of $1.3 million. In the same year, American Mortgage Insurance Company (AMI) was chartered in North Carolina and also began insuring residential loans. One year later (1962), United Guaranty Residential Insurance Company was licensed in Louisiana and began providing insurance for conventional mortgages. The Investors Mortgage Insurance Company (IMI) was chartered in Illinois in 1968.

The concept of private mortgage insurance gained credibility during the 1960s, and from 1960 to 1970 private mortgage insurance in force increased from $300 million to $7.3 billion. Lenders, particularly savings and loan associations, become increasingly willing to make privately insured, low down payment loans. During the industry's first 10 years, these five firms were able to expand without facing much intra-industry competition.

New kinds of mortgage insurance policies emerged during the 1960s which defined premium rates and coverage to meet particular lender requirements. The basic coverage and payment plan that MGIC had introduced in 1957, however, continued to be the most popular.

The potential market for private mortgage insurance expanded greatly in the early 1970s as changes were made in FHLBB's regulations. These new regulations permitted federally chartered savings and loan associations to allocate larger portions of their portfolio to high LTVR loans. During the 1960s, members of the Bank Board were gradually permitted to hold larger portfolios of loans with up to a 90 percent LTVR. Regulations during the early 1970s substantially increased the percent of total assets that they could hold in 80 to 90 percent loans, and for the first time allowed them to hold loans with a LTVR of between 90 and 95 percent.

Subsequently, FHLBB regulations have been changed to: (1) increase to 25 percent the portion of a savings and loan's assets which currently can be held in mortgages with LTVRs greater than 90 percent, and (2) increase to 50 percent the portion of assets which may be invested in loans of greater than an 80 percent LTVR. This change has increased these lenders' willingness and ability to make loans requiring low down payments.

Two legislative changes that occurred as a result of the Emergency Home Finance Act of 1971 substantially increased the marketability of privately insured loans and provided a substantial impetus to the growth of the mortgage insurance industry. The Act mended FNMA's charter to permit its purchase of lower down payment conventional mortgages under the condition that the unpaid principal balance above 75 percent be insured by an approved insurer. The Act also created the Federal Home Loan Mortgage Corporation for the purpose of purchasing conventional residential mortgages from savings and loans, and reselling them, subject to restrictions similar to those used by FNMA.

The number of mortgage insurers expanded during the early 1970s as privately insured loans became more marketable to thrift institutions and other secondary market investors. Nine new firms began operations in the industry between 1972 and 1976. Exhibit IV-2 identifies each of these firms.

These new firms entered the industry during a period in which it experienced nearly exponential growth. Private mortgage insurance in force nearly doubled every two years between 1970 and 1974 and then experienced a small decline in the rate of growth in 1975. Many of the newer and smaller firms directed their efforts toward establishing a local or regional market penetration and did not attempt to compete nationally with the larger, more established, and better capitalized firms.

The Growth In Popularity Of Insured Conventional Mortgages

Exhibit IV-3 demonstrates the dynamic growth which the residential mortgage market has experienced in the 1970s, and the contribution made to it by the private mortgage insurance industry. Mortgages debt outstanding increased about 125 percent between 1970 and 1978, but during that same period private mortgage insurance in force increased more than ten-fold. In 1970, 2.5 percent of mortgage debt outstanding for one- to four-family units was privately insured; at the end of 1978, this proportion had increased to 12 percent.

Many factors contributed to the explosive expansion of the residential mortgage market during the 1970s (a more detailed discussion is included in the base line study on mortgage lenders). However, private mortgage insurer's success was due ultimately to the tremendous latent demand for conventional mortgage loans requiring low down payments. Changes in FHLBB regulations and the enactment of the 1971 Emergency Home Finance Act aided by expanding both the primary and secondary markets for these privately insured loans which, in turn, significantly expanded the population of qualified home buyers.

A comparison of the development of FHA-insured and VA-guaranteed loans demonstrates this point. Until about 1970, the only way these home buyers could obtain a loan was to qualify for either FHA-insured or VA-guaranteed

EXHIBIT IV-2

MORTGAGE INSURERS ORGANIZED SINCE 1970

NAME	HEADQUARTERS	YEAR ORGANIZED
TICOR Mortgage Insurance Co.	Los Angeles, California	1972
PMI Mortgage Insurance Co.	San Francisco, California	1972
Republic Mortgage Insurance Co.	Winston-Salem, North Carolina	1972
Foremost Guaranty Corp.	Madison, Wisconsin	1972
Home Guaranty Insurance Corp.	Richmond, Virginia	1972
Integon Mortgage Guaranty Corp.	Winston-Salem, North Carolina	1972
Commercial Credit Mortgage Insurance Co.	Baltimore, Maryland	1974
Pennsylvania Mortgage Insurance Co.	Bluebell, Pennsylvania	1974
Commonwealth Mortgage Assurance Co.	Philadelphia, Pennsylvania	1976

SOURCE: 1978 NAIC Statutory Statements.

EXHIBIT IV-3

GROWTH IN MORTGAGE DEBT OUTSTANDING [a] AND IN PRIVATE MORTGAGE INSURANCE IN FORCE 1955 – 1979

YEAR	TOTAL MORTGAGE DEBT OUTSTANDING [a] (Billions)	PRIVATE MORTGAGE INSURANCE IN FORCE [b] (Billions)	PERCENT OF TOTAL MORTGAGE DEBT [a] COVERED BY PRIVATE MORTGAGE INSURANCE
1955	$ 88.2	–	–
1960	141.9	$ 0.3	0.2%
1965	220.5	3.6	1.6
1970	298.1	7.3	2.5
1972	372.8	17.5	4.7
1974	449.9	33.5	7.5
1976	558.4	49.3	8.8
1978	675.0	81.1	12.0
1979	785.8	95.2	12.1

[a] For one-to four-family units.

[b] Insurance-in-force figures represent 100 percent of the unpaid principal balances of insured mortgages.

SOURCES: Henry J. Aaron, "Shelter and Subsidies," Studies in Social Economics (Brookings Institute), 1978.
HUD News (HUD No. 79-264, August 1979).
HUD News Release (HUD No. 80-186, June 1980).

loans. Exhibit IV-4 shows how significantly this changed in the 1970s. Total FHA-VA mortgage debt outstanding increased about $60 billion, or 61 percent, between 1970 and 1978. Private mortgage insurance in force, however, increased nearly $75 billion. By the end of 1978, privately insured loans accounted for nearly 35 percent of all insured or guaranteed residential mortgage debt outstanding. The popularity of privately insured conventional loans over those offered through Federal Government Programs is demonstrated further in Exhibit IV-5. In every year since 1972, private mortgage insurance has accounted for more than half of the net additions to insured or guaranteed mortgage debt oustanding.

The last three years in particular have seen a tremendous expansion in the residential mortgage market. This trend, however, may not necessarily continue into the 1980s. If mortgage money is relatively tight, many conventional lenders will follow the practice of rationing mortgage money first to those borrowers able to make the largest down payments. As a result, conventional privately insured loans may provide a smaller proportion of combined insured and guaranteed loans.

FEATURES OF THE INSURANCE PRODUCT AND DELIVERY PROCESS

The mortgage insurance product is, in theory, very similar to the FHA 203 single-family mortgage insurance program. The private mortgage insurance industry, however, has developed a product that is both more flexible and more comprehensive. It includes: (1) the delivery of the traditional insurance product that assumes the transfer of certain, well-defined risks; and (2) the delivery of certain ancillary services designed to fulfill a broad range of needs of lender customers. The following analysis reviews the type of coverage typically selected by lenders and describes the type and amount of risk that is transferred from lender to insurer as a result of the insurance coverage.

The availability of private mortgage insurance has had a substantial impact upon both the lender's willingness to make conventional, high loan-to-value ratio loans, and upon the saleability of those loans to secondary market investors. In addition to the basic insurance provisions, a broad range of ancillary services contribute to the saleability of these loans and to maintaining a smooth, liquid resale market for them. Those services are also described in some detail within this chapter.

Private mortgage insurance became an increasingly important element in allowing home buyers to qualify for permanent mortgage financing during the decade of the 1970s, and as such, this insurance service plays an important role in the real estate settlement process. To better understand the process involved in delivering this service, this section will trace both: (1) the insurance approval process from the time of loan application to the time at which the insurer sends a Commitment Certificate to the lender; and (2) the claims process from the point of mortgagor delinquency through the options available for complete claims settlement between the insurer and the lender.

EXHIBIT IV-4

GOVERNMENT INSURANCE OR GUARANTEE VS. PRIVATE INSURANCE FOR MORTGAGE DEBT OUTSTANDING [a]

1955 – 1979

YEAR	OUTSTANDING MORTGAGE DEBT: FHA-INSURED AND VA-GUARANTEED (Billions)	PRIVATE MORTGAGE INSURANCE IN FORCE [b] (Billions)	PRIVATE INSURANCE AS A PERCENTAGE OF TOTAL (INSURED-GUARANTEED) (Billions)
1955	$ 38.9	$ –	–
1960	56.4	0.3	0.5 %
1965	73.1	3.6	4.7
1970	97.3	7.3	7.0
1972	113.0	17.5	13.4
1974	121.3	33.5	21.6
1976	133.5	49.3	24.9
1978	156.6	81.1	34.3
1979	181.0	95.2	34.5

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[a] For one- to four-family units.

[b] Insurance-in-force figures represent 100 percent of the unpaid principal balance of insured mortgages.

SOURCES: Economic Report of the President, January 1977.
HUD News (HUD No. 79-264, August 1979).
HUD News Release (HUD No. 80-186, June 1980).

EXHIBIT IV-5

MORTGAGE DEBT OUTSTANDING:[a] NET ADDITIONS TO GOVERNMENT INSURED OR GUARANTEED VS PRIVATELY INSURED 1955 – 1979

PERIOD	NET ADDITIONS[b]		PRIVATE NET ADDITIONS AS A PERCENTAGE OF TOTAL NET ADDITIONS[b]
	GOVERNMENT INSURED/GUARANTEED (Billions)	PRIVATELY INSURED (Billions)	
1955 - 1960	$17.5	$ 0.3	1.7%
1960 - 1965	16.7	3.3	16.5
1965 - 1970	24.2	3.7	13.3
1971	8.0	2.3	22.3
1972	8.3	7.9	48.8
1973	3.2	9.9	75.6
1974	5.1	6.1	54.5
1975	5.8	6.4	52.5
1976	6.4	9.4	59.5
1977	10.9	13.7	55.0
1978	12.3	18.0	59.4
1979	24.4	14.1	36.6

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[a] For one- to four-family units.

[b] Net additions are the difference in total outstanding principal balance between the beginning and the end of a time period.

SOURCES: Economic Report of the President, January 1977.
HUD News (HUD No. 79-264, August 1979).
HUD News Release (HUD No. 80-186, June 1980).

The Mortgage Insurance Product

Private mortgage insurance is a financial service provided to mortgage lenders who require such insurance when making a conventional mortgage loan to a home buyer unable (or unwilling) to make a traditional 20 to 25 percent down payment. In providing this service, the mortgage insurer agrees to absorb a set portion of the loss that would result from a borrower's default on his mortgage obligation. This insurance encourages the lender to make high LTVR loans by allowing him to transfer to a third party some of the risk inherent in such mortgage lending.

Forms Of Coverage

The lender typically determines the amount of insurance or coverage that is necessary, but this decision is often influenced by both regulations (of, for instance, the Federal Home Loan Bank Board) and by the needs of secondary market investors (including the Mortgage Corporation, the Federal National Mortgage Association, and private financial institutions). Such insurance coverage is usually defined as a percentage of the loan amount for which the insurer will assume a risk of loss.

The two most popular insurance plans are the 95/25 plan, and the 90/20 plan. Loans accompanied by a down payment ranging from 5 percent up to (but not including) a full 10 percent, typically require coverage under the first plan, which provides coverage for the top 25 percent of the oustanding loan amount. For instance, if a borrower made the minimum 5 percent down payment, coverage under this plan would reduce the lender's risk from 95 percent of the purchase price or appraised value of the property, down to 71.25 percent of its value (the remaining 75 percent of the 95 percent loan amount). This would be roughly equivalent to the security that would have been provided by a 28.75 percent down payment.

The 90/20 plan provides coverage for loans accompanied by a down payment of from 10 percent up to 20 percent. In this case, the insurance provides coverage for the top 20 percent of the outstanding loan amount. In the case of the minimum 10 percent down payment, the lender's risk would be reduced from 90 percent down to 72 percent (i.e., 80 percent of the 90 percent loan amount).

As a result, the amount of risk borne by the insurer, may be defined in terms of two simple variables: (1) the percentage of the purchase price that the borrower is able to pay; and (2) the percentage of the resulting loan amount that the insurer is willing to cover. Each defines an amount of risk that will be absorbed by the insurer, and each different combination might warrant a different premium charge. These combinations can be graphically presented by a simple matrix (see Exhibit IV-6) measuring loan risk (expressed as a loan-to-value ratio) across one axis and the amount of coverage provided by the insurer along the other.

EXHIBIT IV-6

LENDER RISK ACCORDING TO LTVR AND INSURANCE COVERAGE

	LOAN-TO-VALUE RATIO			
INSURANCE COVERAGE	80%	85%	90%	95%
12%	(.70)	(.75)	(.80)	
16%				(.80)
17%		(.71)	(.75)	
20%	(.64)	(.68)	(.72)	(.76)
25%	(.60)	(.64)	(.68)	(.71)
30%				(.67)

SOURCE: PMM&CO. Mortgage Insurer Survey, February 1980.

These insurance policy plans are designed to provide lenders with protection equivalent to that provided by much higher down payments. As a result, categories of coverage have been introduced that reduce a lender's risk to that equivalent to traditional down payments of 20 percent, 25 percent, 30 percent, and even 33 percent. The relationship between lender risk and different combinations of LTVR and insurance coverage are shown in Exhibit 6. As mentioned earlier, the two most popular plans are the 20 percent coverage for a 90 percent LTVR loan (the 90/20 plan), and 25 percent coverage for a 95 percent LTVR loan (the 95/25 plan). Both provide the lender a risk exposure of about 72 percent, which fulfills the requirements of many secondary market investors that loans be insured to below 75 percent of the loan value.

Ancillary Services

Two sets of circumstances contribute to the diverse and expanding services and activities provided by the private mortgage insurer. The first relates to the basic nature of the insurance product. It is nearly uniform across insurers, and although new product and pricing variations have developed with some frequency over the past two to three years, each insurer offers a mix of insurance products that is nearly identical to that mix offered by other insurers. Variations in product and pricing are discussed in much greater detail in Part 2 of this volume under the theme of competition.

However, a second set of circumstances has fostered the development of additional services and ancillary products throughout the industry. This is because the relationship between lender and insurer represents a classic example of reverse competition. Although the borrower directly pays for the insurance coverage, the lender or secondary market investor is the beneficiary, and it is they who establish the requirement for such insurance. As a result, the lender requires insurance that will meet his particular needs (be they either to hold or to sell the loan), and in practice, neither his requirements nor his selection of the insurer is significantly influenced by the price paid by the consumer.

The process of selecting the mortgage insurer is discussed in greater detail in Chapter XI. However, at this point it is interesting to describe the frequency with which the borrower participates in the selection process. During our interview process, lenders were asked if they regularly allowed the borrower to participate in the selection of the mortgage insurer from among a group with whom the lender had a master policy. About one out of six (16.8 percent) replied affirmatively to this question. Mortgage bankers allowed borrowers to participate most frequently (27.3 percent), as an institutional group, savings and loans allowed such borrower selection least frequently (9.0 percent).

The range in responses differed more greatly across geographic areas (SMSAs) than across institutions. Nearly a third (32.1 percent) of the Seattle lenders regularly allowed borrower participation in the selection process, in Jacksonville 28.6 percent of the respondents so replied. However, in Boston (where only 5 percent of the lenders regularly allowed borrower input in selecting the mortgage insurer) and in Washington, D.C. (8.8 percent), borrower selection was much more infrequent (see Exhibit IV-7).

This suggests that the lender is primarily responsible for the selection of the mortgage insurance firm, but the insurers perceive them as having an even more important role in the decision making process. All 14 insurers felt that the mortgage lender was responsible for their selection at least 90 percent of the time; nine insurers attributed their use to lender selection at least 99 percent of the time. Some insurers identified real estate agents and builders as responsible for their selection as much as 5 percent of the time, and no more than one percent of any one insurer's business was believed to be referred by other settlement-related parties (a title company representative, attorney or other settlement agent).

To reinforce their individual appeal to a mortgage lender, private mortgage insurers have a wide range of ancillary services that include, but are not limited to: (1) third-party review; (2) sales and marketing support; and (3) secondary market assistance.

Third-Party Review. Lenders have become increasingly dependent upon the third-party loan review that is performed by the mortgage insurer as part of the insurance appraisal process. By basing this insurance approval upon an examination of all relevant borrower, credit, and property information, the insurer lends confidence to a lender's decision to approve a loan application. The insurer's examination is often based upon a standard automated underwriting system permitting some firms to set a standard of a 24-hour turnaround in providing this decision. Such quick confirmation of the underwriting decision has increased lenders' reliance upon the third-party review service.

Service. An insurer can distinguish himself in providing service to a mortgage lender by both providing the common services better and by providing unique or custom services. Throughout our interview process, mortgage insurers described their industry as a personal service business, and as a result, service of a fast and high quality is very important. This kind of service includes a local underwriting office, where personnel are familiar with both lenders and housing markets and can make available quick decisions regarding rejection or approval of insurance applications. Service involves assistance in the preparation of documents, and some insurers have automated systems that are designed to complete needed FNMA/FHLMC documents and Truth-in-Lending forms that would otherwise be more time-consuming for the lender to complete.

A quality that is most important from the lender's perspective is the promptness with which an insurer can process, and make payment on, claims that are presented. Because quick processing of claims often depends upon the level of good faith that exists between lender and insurer, and upon their long-standing relationship, this service strongly encourages lenders to concentrate their insurance with a small group of insurers.

EXHIBIT IV-7

FREQUENCY OF BORROWER PARTICIPATION IN THE SELECTION OF THE MORTGAGE INSURER

PERCENT OF 'YES' RESPONSES WHEN ASKED IF BORROWER WAS REGULARLY ALLOWED TO PARTICIPATE IN THE SELECTION OF THE MORTGAGE INSURER

COMMERCIAL BANKS	SAVINGS & LOANS	MUTUAL SAVINGS/BANKS	MORTGAGE BANKERS	TOTAL
14.3%	9.0%	20.0%	27.3%	16.8%

BOSTON	WASHINGTON, D.C.	JACKSONVILLE	SAN ANTONIO	ST. LOUIS	DENVER	LOS ANGELES	SEATTLE	TOTAL
5.0%	8.8%	28.6%	17.9%	18.2%	14.3%	12.9%	32.1%	16.9%

SOURCE: PMM&CO. Lender Survey, February 1980.

Sales and Marketing Support. Some of the custom services provided by insurers include the training of lender staff in the use of alternative mortgage insurance programs to qualify otherwise marginal borrowers. Some insurers also provide their customers with sales and marketing brochures and displays directed at enhancing the borrower's understanding of the mortgage lending and the mortgage insurance process. Sometimes a better understanding of real estate investment and mortgage insurance will encourage a borrower to apply and qualify for a larger loan than he might otherwise.

Secondary Market Assistance. The secondary mortgage market has developed significantly during the 1970s, and private mortgage insurers have played a key role in this expansion. Mortgage insurers are able to provide a contact or brokerage function by bringing together investors (primarily savings and loans but also insurance companies and some pension funds) with those savings and loans and other primary lenders who are able to originate more loans than they choose to hold in their own portfolios. The mortgage insurers provide this service at no charge and can do so efficently because they are continuously in contact with primary and secondary market lenders, and are familiar with their investment and placement requirements.

Insurers also provide secondary market assistance in the form of counseling or explaining to lenders the operations of both FNMA and FHLMC commitment processes. This specialized assistance in understanding the workings of the secondary mortgage market and in structuring bids to both of these secondary market buyers is particularly useful to smaller financial institutions or those that are less experienced in the secondary market.

Some insurers have taken their brokerage service a step further by actually purchasing and pooling whole loans from a group of lenders and selling participation interests in them. MGIC recently formed a subsidiary, Maggie Mae, which sold its first securities backed by mortgage pools in August 1979. PMI has also created an affiliate company called Pennie Mae and has issued similar securities.

Another important secondary market service which mortgage insurers have recently provided has been the development of pool insurance for pass-through securities issued by large mortgage lenders. Such insurance is necessary in order to induce more investors to purchase these mortgage-backed securities. Furthermore, public offerings of these securities are eligible for Standard and Poor's AA rating only if such pool insurance is provided. Generally, this pool insurance provides 100 percent coverage for the top 5 or 10 percent of the principal balance of mortgages backing a security issue. The insurance is provided on a fee basis and is subject to competitive bidding by the mortgage insurers.

Role of Ancillary Services

The mortgage insurance industry has made a significant financial commitment to developing a broad, competent array of services that can be of use to their lender-customers. This includes a network of local underwriting offices, a marketing and sales staff responsible for maintaining personal reltionships with lending institutions, and a staff of secondary market specialists who maintain a brokerage market for institutions active in buying and selling mortgages. We interviewed representatives of each of the mortgage insurers and asked them to identify the most important reason they felt a lender would select their insurance company instead of one of their competitor's.

Six of the 14 firms responded that service was the most important reason for their selection. As indicated, this range of services can take many forms, but it primarily emphasizes prompt payment of claims and individual service and consultation provided by the sales representative. Four of the 14 insurers identified their ability to maintain a national population of secondary market contacts that could facilitate both the sale and purchase activity. The final group of four insurers agreed that their firm's financial strength and their established ability to "stand behind" claims made upon them, was the distinguishing factor that led to their selection.

The Insurance Delivery Process

The delivery of mortgage insurance involves two very specific activities that occur: (1) at the beginning of the borrower's application, and (2) if foreclosure is necessary, and the borrower is no longer involved when a claim is filed by the lender. Following settlement, when the borrower remains current in his monthly payments to the lender (or servicer), the insurer's responsibilities are limited to collecting annual premiums and to servicing lenders, rather than individual loans. These two activities, the approval process and the claims process, are described below.

The Insurance Approval Process

Prior to applying for mortgage insurance on an individual loan, a lender must first obtain a master policy with the firm from which it desires to obtain insurance. A master policy is a statement of terms and conditions under which the mortgage insurer and loan originator agree to do business. It imposes no legal obligation on the lender to insure mortgages with that particular insurer. The master policy defines: (1) the procedures required of the lender to insure a particular mortgage loan; (2) the procedures required of the lender in case of default by the borrower; (3) the method by which the insurer's claim liability is determined; and (4) the payment procedures available to the insurer in reimbursing the insured portion of the lender's losses.

To obtain a master policy, the lender describes the types of loans he wishes to insure and identifies the organization that examines or supervises the lender's operations. Lenders are also required to submit audited financial statements and resumes of the firm's executives for insurer review. As a rule, all master policy applications are accepted by insurers unless fraud or misrepresentation is suspected. Once the application is approved, the lender may insure mortgage loans under any of the number of policies offered by the mortgage insurer.

The number of master policies that insurers had outstanding ranged from a low of 650 to nearly ten times that amount, but we did not find this number of policies to correlate closely with insurance written. There are a number of reasons for this. Some lenders may maintain inactive master policies, and other insurers may issue a different master policy to each of a single S&L's branch offices. Among the mortgage insurers who felt they could answer this question with any accuracy (two declined), the average number of policies outstanding was about 2,900.

It is more interesting to look at this issue from the perspective of the mortgage lender. The average number of reported master policies was 5.6, and the model response was master policies with 4 mortgage insurers. Exhibit IV-8 indicates that commercial banks and savings banks tend to concentrate their mortgage insurance business most; more than one-third of the S&Ls and mortgage bankers indicated that they had master policies with seven or more mortgage insurers. By SMSA, lenders in Boston tend to limit their number of master policies most; in Washington and St. Louis, more than 40 percent of the lenders reported master policies with seven or more insurers.

Only after a lender has a master policy can he submit a loan for insurance approal. Before doing so, the lender first examines the prospective homebuyer's credit and employment status to assure himself of the borrower's credit worthiness. He then mails a number of insurance application documents to the insurer for his approval. These typically include: (1) borrower's loan application; (2) borrower's current credit report; (3) a current property appraisal (and photograph); (4) borrower's employment verification; and (5) a copy of the sales contract. At this time of application, the lender will specify the type of insurance policy that he wishes to purchase for the particular loan.

A local underwriting office reviews these documents and evaluates patticular income, liability, and credit data, often by means of a centralized underwriting software package. The local underwriter has authority to reverse a rejection decision made by the system, but he is generally limited to specific loan amounts that he may approve. He relies upon his knowledge of the lender and local housing market conditions to make the final decision. That decision is then sent in writing to the lender. If insurance is approved, the insurer mails the commitment/certificate of insurance to the lender. A copy of the buyer-seller affidavit, which legally binds the buyer and seller at time of closing, is later forwarded to the insurer.

One significant reason why the private mortgage insurance industry has grown so rapidly is its ability to execute this approval process within a 24-hour period. This quick turnaround has increased lenders' dependence upon insurers' third-party loan reviews. The entire insurance approval process is displayed in a flow chart in Exhibit IV-9.

EXHIBIT IV-8

DISTRIBUTION OF INSTITUTIONS HAVING MASTER POLICIES WITH DIFFERENT MORTGAGE INSURERS

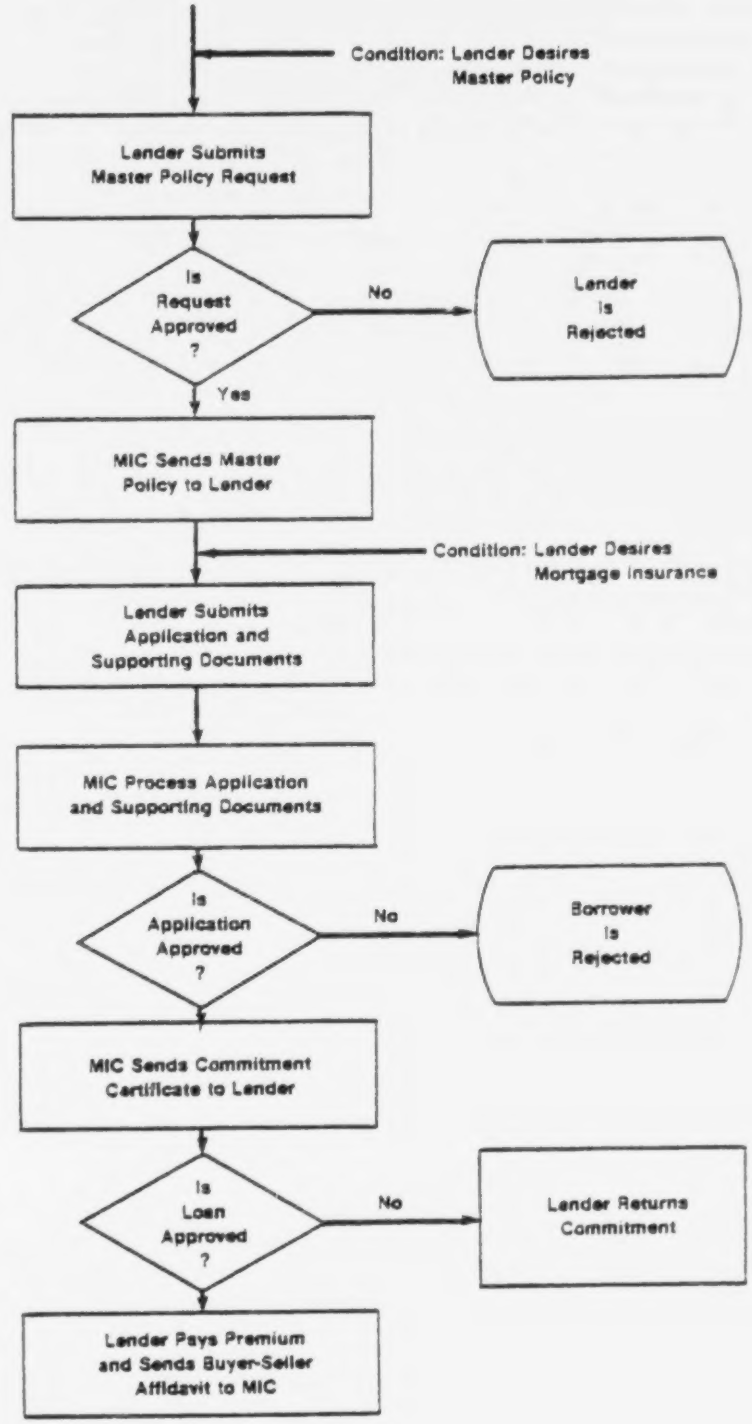
NUMBER OF MASTER POLICIES	COMMERCIAL BANKS	SAVINGS & LOANS	MUTUAL SAVINGS BANKS	MORTGAGE BANKS	TOTAL
1-3	36.0	18.0	37.5	12.5	19.7
4-6	52.0	44.2	50.0	54.2	49.0
7-10	12.0	31.6	12.5	27.8	26.5
more than 10	0.0	6.2	0	5.5	4.8
Total	100.0	100.0	100.0	100.0	100.0

NUMBER OF MASTER POLICIES	BOSTON	WASHINGTON, D.C.	JACKSONVILLE	SAN ANTONIO	ST. LOUIS	DENVER	LOS ANGELES	SEATTLE	TOTAL
1-3	42.8	15.2	20.0	33.3	31.6	12.1	10.0	7.4	19.7
4-6	52.4	33.3	45.0	50.0	26.3	60.6	63.3	51.9	49.0
7-10	4.8	36.4	30.0	12.5	42.1	24.3	23.3	37.0	26.5
more than 10	0	15.1	5.0	4.2	0.0	3.0	3.4	3.7	4.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT IV-9

THE INSURANCE APPROVAL PROCESS


Condition: Lender Desires Master Policy
Lender Submits Master Policy Request
Is Request Approved ?
No
Lender Is Rejected
Yes
MIC Sends Master Policy to Lender
Condition: Lender Desires Mortgage Insurance
Lender Submits Application and Supporting Documents
MIC Process Application and Supporting Documents
Is Application Approved ?
No
Borrower Is Rejected
MIC Sends Commitment Certificate to Lender
Is Loan Approved ?
No
Lender Returns Commitment
Lender Pays Premium and Sends Buyer-Seller Affidavit to MIC

SOURCE: PMM&Co., 1980.

The Insurance Claims Process

The master policy defines conditions under which a borrower is considered delinquent in the repayment of his mortgage loan. These delinquency conditions are usually met when a loan payment is four months overdue. At that time, the insured lender is required to submit a notice of delinquency to the mortgage insurer. Master policies also generally require that a lender file a monthly status report until the insured, delinquent borrower brings the account current, or until the lender obtains title to the property. The master policies of most insurers require that the lender, through voluntary conveyance, judicial proceedings, or nonjudicial proceedings, obtain a merchantable title to the property before submitting an insurance claim form. In submitting the claim form, the lender indicates his desire to either: (1) sell the house to recover some or all of the claim amount, or (2) convey title to the insurer and claim according to the individual policy. The individual policy specifies the insurer's liability to the lender as some set portion (12 to 30 percent) of the lender's claim. The amount which the lender claims as a loss to him as a result of the default equals the sum of:

- the current principal balance;
- accumulated interest from the date of default to the claim date;
- real estate taxes and hazard insurance necessarily advanced by the lender;
- other expenses necessarily incurred by the lender in preservation of the mortgaged real estate;
- court costs; and
- reasonable attorney's fees not exceeding 3 percent of the principal and interest due.

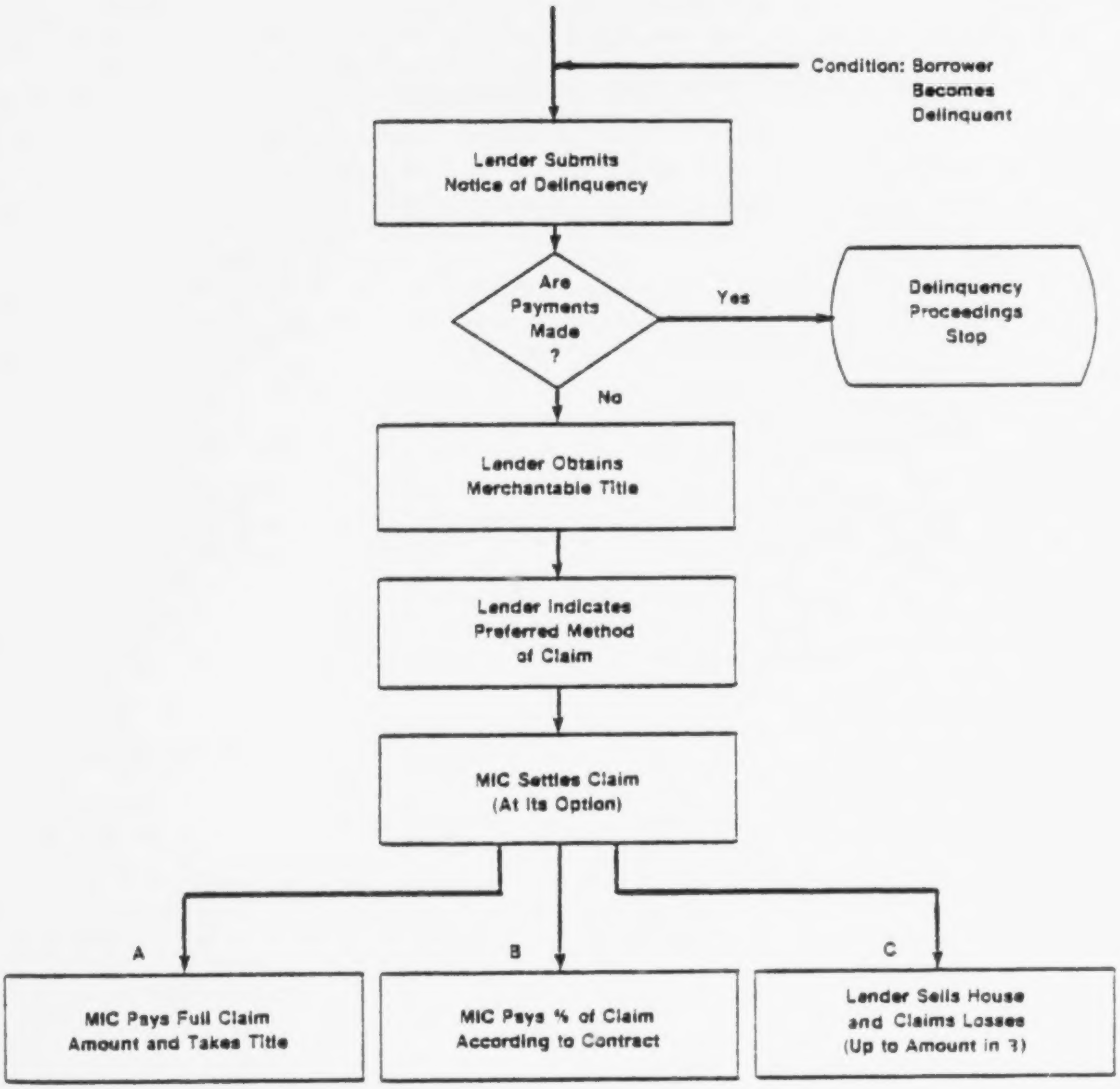
The mortgage insurer may, at his option, settle the claim by any of the following three methods:

- accept title to the property, free and clear of all liens and encumbrances, and pay the lender the entire amount of the claim; or
- relinquish all claim to the property and pay the lender a percentage of the claim (specified in the policy covering the loan); or
- permit the lender to sell the property and reimburse the lender for his actual loss, computed by subtracting the net proceeds of the sale from the total amount claimable under the policy. (The loss, however, cannot exceed the percentage options.)

The entire insurance claim process is presented in flow chart form in Exhibit IV-10.

EXHIBIT IV-10

THE INSURANCE CLAIMS PROCESS


Condition: Borrower Becomes Delinquent
Lender Submits Notice of Delinquency
Are Payments Made ?
Yes
Delinquency Proceedings Stop
No
Lender Obtains Merchantable Title
Lender Indicates Preferred Method of Claim
MIC Settles Claim (At Its Option)
A
B
C
MIC Pays Full Claim Amount and Takes Title
MIC Pays % of Claim According to Contract
Lender Sells House and Claims Losses (Up to Amount in B)

SOURCE: PMM&Co., 1980.

PRICING OF MORTGAGE INSURANCE

The mortgage insurance industry is characterized by 14 firms who offer conventional mortgage lenders insurance products that are nearly indistiguishable. Some lenders differentiate the quality of the basic insurance coverage by evaluating the balance sheet and the basic financial strength of the insurer, but more frequently differentiation among mortgage insurers is based upon the services (unrelated to mortgage insurance) they can deliver, and not upon the basic insurance that they sell.

There has been little pricing variation in mortgage insurance since the industry began in 1957. However, a significant amount of variation has developed in terms of: (1) how the amount of insurance coverage is defined; and (2) how that insurance coverage is paid for. This section discusses briefly some of these variations, and serves as a background for pricing issues that are considered in Part 2. Prior to that discussion, however, a background to current industry pricing practices is warranted.

Historical Perspective on Pricing

In his 1934 report on the liquidated New York State private mortgage insurers, Commissioner Alger identified a number of regulations under which a private mortgage insurance industry would likely survive as a viable business organization. He was strongly in favor of the adoption of conservative investment and accounting practices, and he supported the use of standard appraisal and underwriting techniques and the separation from mortgage guaranty firms of other real estate service providers such as real estate brokers, mortgage lenders, and title insurers.

In his report, Commissioner Alger recommended that servicing charges and guarantee fees be limited to an aggregate of 0.50 percent annually of the mortgage's outstanding principal balance. Also in 1934, the Federal Housing Administration developed a single-family insurance program which called for an annual insurance premium equal to 0.50 percent of the loan's principal balance. This premium amount was based upon an actuarial equation that recognized borrower and property risk and that incorporated the prospective reserve method used in the determination of life insurance premiums.[1]

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[1] Graaskamp, James. "Development and Structure of Mortgage Loan Guaranty Insurance in the United States," The Journal of Risk and Insurance, Vol. 34, (March 1967) pp. 47-66.

This FHA program for insuring single-family homes proved to be a tremendous success; it experienced only small losses due to claims and was able to build up rather large reserves. This model attracted the attention of the founders of MGIC, who felt that a similar type of insurance could again safely be provided for conventional, high loan-to-value ratio mortgage loans. In the words of Dr. James Graaskamp,

> If the FHA record were studied for the conventional loan with 10 percent or more downpayment and for programs without intent to provide ownership for special groups, then it would be argued that the marginal cost of assuming the total appraisal, inspection, and credit analysis burden to standardize and control the mortgage loan process was not justified by a corresponding marginal savings in terms of foreclosure loss avoided.
>
> The private guarantor assumed that his administrative savings would be far greater than the cost of his underwriting errors, thereby justifying issuance of a guarantee for the high ratio loan at a cost significantly lower than comparable FHA coverage.[1]

The cost of coverage made available by the initial mortgage guarantors was 0.50 percent of the principal balance for the first year of the loan, and reduced to 0.25 percent of the declining loan balance for subsequent years. It is not surprising that the initial year's premium was priced comparable to that of FHA insurance. The private guarantor insurance alternative was attractive because it offered the mortgage lender an underwriting and approval process that could be more easily adopted to his requirements, and promised a decision in less time and with less paperwork. A single premium plan was also available which provided insurance coverage for a one-time, front-end charge of 2 percent of the loan amount.

Since those premium plans were made available more than 20 years ago, new payment plans and different categories of coverage have become commonplace within the industry. Motivation for these variatios has originated both from an interest to specifically meet the insurance requirements of a lender or investor, while spreading out the cost of mortgage insurance over a longer period of time. Primarily as a result of this latter interest, the use of annual renewal payment plans has almost entirely replaced the single, prepaid plans. In responding to our questionnaire, insurers indicated that 90-95 percent of the new insurance they write is in the form of annual premium plans. Respondents to our lender questionnaire indicated that over 92 percent of the policies they use are annual renewal policies.

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[1] Ibid., pp. 57-58.

Fixed renewal premium plans (based upon the original principal loan balance rather than upon a declining, amortized loan balance), have been introduced as an alternative to the renewal premiums which change annually as the principal balance declines. These fixed renewal plans have become more popular because their constant premium amounts that last the life of the insurance policy provide for easier servicing.

In the past two to three years, additional innovations have been developed. Several insurers have introduced premium payment plans that spread initial, first-year premium charges over the first few years of the loan. These plans, called closing saver plans, are designed to further reduce the total settlement charges required by a borrower at the time of closing. These policies specify a minimum period during which they must be maintained in force; all other policies are may be cancelled by the lender at any time following settlement.

Although the premium rates under these alternative policy payment plans are different, they represent little present value difference from the standard payment plan. In fact, premium rates have been relatively constant for most of the period since 1957. Prior to 1976, insurers charged a $20 processing fee for each insurance application submitted, and this charge was typically passed on by the lender to the borrower. However, in 1976, one of the firms within the industry eliminated this charge, and each of the other firms followed.

The amount or value of the premiums, however, had remained relatively consistent until recently. During the past four to five years, some of the smaller insurers have used reduced premiums as a marketing tool to break into a market area or to develop greater market share. All of the mortgage insurers have reduced their premiums for specific plans in specific states at one time or another during the past two years, and most of the insurers whom we interviewed admitted that these reductions were made to match reductions made by competitive firms. The impact of these price reductions will be discussed in greater detail in Chapter XI.

Premium Payment Plans

Although the single premium plan is used only infrequently, each of the 14 mortgage insurers currently allow insurance premiums to be paid by either this method or the annual (renewal) premium plan. The prepaid plan is significantly more costly to the consumer at the time of settlement, but some lenders prefer it because it reduces the servicing burden which they must perform if monthly payments do not have to be accounted for, and annual payments to insurers need not be made. Each of these two plans is described briefly below.

Annual Premium Plans. The annual or renewal premium plan requires that a borrower prepay only the first year's insurance premium at settlement. This first-year premium is usually one percent of the loan amount if less than a 10 percent down payment is made. Under the renewal premium plan, the lender is typically required to escrow one-twelfth of the subsequent annual premium at the time that each monthly mortgage payment is made by the borrower. As a result, on the first anniversary date of settlement, the lender should have in escrow the amount necessary to prepay the second year's insurance premium.

Renewal premiums are typically 0.25 percent of the unpaid principal balance, but the industry is becoming increasingly innovative and competitive in pricing these premium charges. Some firms charge less than 0.25 percent of the outstanding principal, and others offer options in which the premiums are fixed for the life of the policy. Level renewal plans allow for a constant annual renewal premium that is typically .24 percent of the original loan amount.

Single Premium Plans. The single premium plan requires the borrower to pay the insurance premium in its entirety at time of settlement. The amount of the premium is determined by the length of time that the lender requires the insurance to remain in force. This time varies from four years up to 15 or 20 years. The single premium varies from 1.5 to 2.75 percent of the loan amount.

The single premium plan is becoming less popular within the industry because of the significant financial burden that it places upon the borrower at settlement. Insurers, however, like the plan because it accelerates payment, and lenders find it attractive because it eliminates the need to escrow for annual payments. Most insurers write less than 5 to 10 percent of their new insurance according to this plan, although there are some geographic areas (Georgia, for example) where it is a customary practice and is used much more frequently.

FIRM AND INDUSTRY OPERATIONS

Organizationally, the mortgage insurance industry is probably the most homogeneous of all the settlement service providers that are discussed within this report. Mortgage lenders differ significantly by type in institution, by the extent to which they are limited to residential mortgage investment, and by their degree of diversification beyond the origination-servicing process. Firms providing real estate brokerage services have become increasingly heterogeneous in terms of both organizational affiliation and their array of available services. Title insurance can be delivered through five distinct channels that may or may not involve intermediaries, and the role of attorneys differs as a function of custom, state regulation, and lender practice. The private mortgage industry is the smallest (in number of firms) described by a common set of practices.

This section discusses the organizational framework that is common to all firms withing the mortgage insurance industry. These firms are similar to most other insurance-related industries, and their opertions are financed both through operational (premium) income and through investment income. The major distinction within this industry is the scope of operations, and basic size and economies of scale contribute significantly to differences among firms within the industry. This section evaluates the financial performance of the 14 firms that make up this industry, and defines the three distinct tiers of the industry in terms of size, market prominence, or scope of operation. The section concludes with a brief individual profile of each of the 14 firms.

Organizational Structure

Nearly all of the 14 mortgage insurers operating in the United States are part of insurance holding company structures. A successful, growing mortgage insurer requires substantial long-term capital to enter the industry and remain solvent until the 10-year contingency reserves required by state law become available. Large insurance holding companies and other diversified and well-capitalized companies are examples of the type of long-term investor needed to finance a mortgage insurer's expansion activities during unprofitable early years.

Exhibit IV-11 presents some relevant information about each of these firms' organization and geographic diversification (by number of underwriting offices and number of states in which licensed), its parent-holding company status, and the composition of its 1978 board of directors.

Many states follow the recommendations of the National Association of Insurance Commissioners (NAIC) and require that private mortgage insurers be single-line carriers--that is, that they sell only one type of insurance. This requirement has enabled most firms to operate within a streamlined organizational structure. Most of the insurance firms are well centralized and have a number of regional underwriting offices located throughout a geographical market. Regional offices are used primarily to base the firm's marketing personnel and to handle the initial insurance application, underwriting, and premium remittances. The annual renewal policies and claims are usually handled by personnel at the firm's headquarters.

The income of private mortgage insurers is generated from two very distinct activities: (1) premiums earned as a result of underwriting activities; and (2) earnings on the reserve accounts which are invested by the insurer.

Income on investment portfolios is typically derived from conservative investment in fixed-income securities, but is nonetheless influenced by swings in the credit markets. Stable investment income allows an insurer to both complement underwriting income and offset part of its losses due to claims.

These proportions are strongly influenced by both the profitable operation (and success at loss containment) of the insurance activity and by the performance of the insurer's investments in the fixed-income and (to a lesser extent) equities markets. Despite the size of its contribution to earnings, investment activity can be efficiently carried out with a relatively small commitment of professional time and resources.

Market Dominance And Industry Structure

Market dominance within the mortgage insurance industry can be described in a number of ways. One may be in terms of the number of lenders who have been issued a master policy by a certain insurer; another may be in terms of

EXHIBIT IV-11

DESCRIPTIVE DATA ABOUT PRIVATE MORTGAGE INSURERS

ORGANIZATION INFORMATION					BOARD OF DIRECTORS INFORMATION								
PRIVATE MORTGAGE USERS	STATE OF INCORPORATION	YEAR OF INCORPORATION	NUMBER OF STATES IN WHICH LICENSED	NUMBER OF UNDERWRITING OFFICES	MORTGAGE BANKER	THRIFT INSTITUTION	COMMERCIAL BANKER	BUILDER/ ATTORNEY	IN HOUSE/ AFFILIATE MGMT.	OTHER	TOTAL	CORPORATE HOLDING COMPANY STATUS
FIRST TIER												
MGIC	Wisconsin	1967	50	32		5		1	3	3	12	99.9% of MGIC's outstanding stock is owned by MGIC Investment Coporation
SECOND TIER												
UNITED	Iowa	1963	46	37		3	1	5	2	2	13	Wholly owned by United Guaranty Corporation of North Carolina.
VEREX	Wisconsin	1961	50	25	2	7		1	2	2	14	Wholly owned by VEREX Corporation which is wholly owned by Greyhound of Arizona.
TICOR	California	1972	50	27	1	3	1	1	6		12	Wholly owned by Title Insurance and Trust Company.
PMI	Arizona	1972	50	15					5	4	9	Wholly owned subsidiary of Allstate Insurance Company, Inc.
AMI	N. Carolina	1961	40	19		3			2	2	7	Wholly owned by AMIC Corporation of North Carolina which is wholly owned by Merrill Lynch Co.
TIGER	Illinois	1968	50	17	3	14		1	1	4	23	Controlled by Tiger Insurance Group, Inc. which is a wholly owned subsidiary of Tiger International.
THIRD TIER												
REPUBLIC	N. Carolina	1972	15	8		13			2		15	Wholly owned by RMIC of North Carolina.
FOREMOST	Michigan	1972	46	14				1	6	3	10	Wholly owned by Foremost Insurance Co. of Michigan
HOME	Virginia	1972	9	2		7		1	1		9	Wholly owned by HGIC Corporation of Virginia.
COMMERCIAL	Maryland	1974	28	8				1	9		10	All outstanding stock owned by Cavalier Insurance Co. which is a subsidiary of Control Data Corporation.
PAMICO	Pennsylvania	1974	19	2		6		1	1	1	9	Wholly owned by Pennsylvania Thrift Services, Inc.
COMMONWEALTH	Pennsylvania	1975	21	8					8		8	Wholly owned by Commonwealth Land Title Insurance Co. which is wholly owned by Reliance Group, Inc.
INTEGON	Georgia	1972	23	3					8		8	Wholly owned by Integon Corporation.
				Totals	6	60	2	13	58	21	158	
				Percent of Total	3.8	38.0	1.3	8.2	35.4	13.3	100.0	

SOURCE: NAIC Statutory Statements filed by mortgage insurance companies, 1979.
Annual reports of mortgage insurance firms, 1978.
PMM&Co. interviews with the mortgage insurance industry, 1980.

the number of lenders with whom the insurer has a near-exclusive relationship. More traditionally, the industry has used such indices as number of applications for insurance, total premiums written during a particular period, or total insurance-in-force at a particular point in time.

Reliable and detailed insurance-in-force statistics are unavailable for individual firms or particular states. This study has used instead the concept of total premiums written as a measure of market share. Such information is available annually on a state-by-state basis for all insurers; it is reported in a consistent manner by all insurers in the annual statements which they file with state insurance comissioners. Furthermore, total premiums written represents a more sensitive indicator to changes in market share than do more aggregated total insurance-in-force figures.

The private mortgage insurance industry is structured in three distinct tiers of firms. The first of these tiers is represented solely by Mortgage Guaranty Insurance Corporation, which is the oldest and most dominant firm within the industry. The second tier is composed of the next six larger firms. Four of these began operation during the late 1960s, and each of these has an active national marketing compaign. The third tier contains the remaining seven firms. Most of these were organized during the 1970s and are concentrated primarily within regional markets. The firms in each of these three tiers are described in the following chart:

First Tier	Second Tier	Third Tier
MGIC	United	Commonwealth
	VEREX	Republic
	TICOR	Foremost
	PMI	Home Guaranty
	AMI	Pamico
	Tiger	Integon
		CCMI

A more detailed description of each of these firms follows in a later section of this report.

Two important factors account for the current structure of the mortgage insurance industry. The most important is the prominent market position won by MGIC by its pioneer role in developing the industry. MGIC has always been the largest mortgage insurer, and it was not until the mid-1970s (when the industry was over 15 years old) that MGIC accounted for less than half of the new, annual premiums written by the entire industry.

A second important factor that has influenced current industry structure has been the increasing level of competitiveness among firms, and the development of locally concentrated marketing efforts. The establishment of local underwriting offices has contributed to this increasing competitiveness. Such concentration is also particularly apparent in some states where domiciled firms have experienced strongly improved market share, or in situtaitons where the market share gain of smaller firms has been at the expense of MGIC, who has been unable to maintain its position within such a dramatically expanding market.

The shift that has taken place in the structure of the mortgage insurance industry is displayed by Exhibit IV-12, which describes changes in national market share by tier group between 1970 and 1979. MGIC, representing the first tier, has seen its share of new annual premiums written decline from over 65 percent in 1970 to 40.6 percent in 1979. MGIC is slowly forfeiting market share to its smaller competitors, but the rate at which it has given up such market share has slowed substantially during the past three years. This does not suggest that MGIC has not been a growing insurer. Its annual premiums written increased from 1976 to 1979 at a compounded annual rate of 15 percent. This has not kept pace with the industry's 21 percent compounded growth rate during that period, but it does nonetheless indicate a strong performance.

Whereas MGIC's market dominance has been declining to a less significant level during the past decade, the second tier firms have predominantly benefited from MGIC's forfeited market share. The six firms that compose this tier have experienced a growth in aggregate share from 34.8 percent in 1970 to 53.6 percent in 1979. The third tier firms have also benefited from MGIC's inability to maintain its dominance over a greatly expanding market. Their aggregate market share increased from 3.4 percent in 1976 to 5.8 percent in 1979.

Chapter XI provides a closer look at both national and state market share among these 14 firms, and it evaluates concentration ratios for both firms and states. These issues are very important in evaluating the adequacy of the current level of competition that exists within the industry. In the next part of this section, a more detailed profile of each of the mortgage insurers is presented.

Profiles of Mortgage Insurers

This section presents relevant information about each of the 14 mortgage insurers active within the United States. Trends and developments in their national market share are identified, along with data on state market share in those ten states in which the U.S. Department of Housing and Urban Development has expressed interest.

First Tier Firm-MGIC

Mortgage Guaranty Insurance Corporation developed an initial monopoly and continues to dominate the private mortgage insurance industry. In 1978, MGIC wrote more than 41 percent of new premiums written by the entire industry--more than 3.5 times as much as the next most active insurer. Because of this prominent position within the industry, MGIC is considered to be the first tier of the industry, and will be addressed separately in our analysis.

MGIC was incorporated in 1957 in the State of Wisconsin. The firm was the first to secure state approval to write mortgage insurance following the collapse of the insurance industry during the Depression. MGIC maintained a mono-

EXHIBIT IV-12

NATIONAL MARKET SHARE BY TIER GROUP IN TERMS OF DIRECT PREMIUMS WRITTEN, 1970 – 1979

	YEAR					
	1970	1973	1976	1977	1978	1979
First Tier	65.2%	60.8%	46.9%	43.1%	41.1%	40.6%
Second Tier	34.8	38.5	49.6	52.3	53.9	53.6
Third Tier	–	.7	3.4	4.5	5.0	5.8
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Size of Market	21,425	154,317	181,396	234,222	297,503	318,041

(Industry Total Direct Premiums Written—000's)

SOURCE: NAIC Statutory Statements (1970 - 1979).

poly on the mortgage insurance market for its first four years of operation and, during that time, was able to generate a nationwide network of underwriters which now writes insurance in all 50 states, Puerto Rico, Guam, and Australia from 31 offices. MGIC is the most geographically diversified and least concentrated of the mortgage insurance firms. The firm wrote only 25.1 percent of its 1978 U.S. insurance in its largest three states and 32.6 percent in its five largest states. The firms which later entered the industry continue to chip at MGIC's share of the market and have reduced it to 41.7 percent at year end 1978, down from 46.9 percent at the end of 1976 and 66 percent at the end of 1972.

MGIC is the principal subsidiary of MGIC Investment Corporation, a Milwaukee, Wisconsin, holding company which owns similar subsidiaries providing commercial and mobile home mortgage insurance. MGIC Investment Corporation recently formed MGIC Mortgage Marketing Corporation, called "Maggie Mae," to aid small and medium-size lenders in pooling mortgage obligations for sale in the secondary market.

The Second-Tier Firms

The middle segment or second-tier within the industry is made up of United, VEREX, TICOR, PMI, AMI, and Tiger. These six firms generated more than 50 percent of the new premiums written in 1978. Each of these, with the exception of the two California firms (TICOR and PMI), were organized during the 1960s.

United Guaranty Corporation. United Guaranty Corporation is the parent organization which operates four mortgage insurance firms: United of California accounted for 12 percent of United's 1978 business, United of Iowa accounted for 42 percent, United of Louisiana accounted for 21 percent, and United of North Carolina accounted for 25 percent. United of Louisiana was organized in 1962 and was the first of these firms to underwrite mortgage loans. The firm is now headquartered in Greensboro, North Carolina. United Guaranty wrote 11.6 percent of new insurance premiums during 1978, down from 12.1 percent in 1976. United ranks second to MGIC in geographic diversification in that only five states provide 35.7 percent of the firm's total 1978 premiums written.

VEREX Assurance, Inc. In 1961, Continental Mortgage Insurance, Inc. (CMI) became licensed and began operations in Madison, Wisconsin, as the second private mortgage insurance firm in the United States. In 1976, CMI merged with Liberty Mortgage Insurance of Ohio, and this combined firm changed its name the following year to VEREX Assurance, Inc. In 1978, VEREX was purchased by the Greyhound Corporation and is now a wholly owned subsidiary.

VEREX is also one of the least concentrated firms within the industry and it appears to be aggressively competing in all 50 states within a network of 25 underwriting offices. In 1978, VEREX ranked third in nationwide market penetration by writing 10.7 percent of new insurance premiums written. This market share declined from about 12.0 percent in 1976.

TICOR Mortgage Insurance Company. TICOR was organized in 1972 in the State of California and is headquartered in Los Angeles. Between 1976 and 1978, it has been the fastest growing firm in the industry, and market share during that period has increased from 6.3 to 9.8 percent. TICOR is more highly concentrated geographicaly than any of the three larger firms in the industry, and it directs its marketing efforts to those parts of the country that are experiencing the greatest growth in population and housing. In 1978, 45.5 percent of TICOR's total premiums written were originated in California and Texas.

TICOR is a wholly owned subsidiary of Title Insurance and Trust Company, the largest title insurer in the United States. This relationship has allowed TICOR to capitalize on its parent firm's extensive financial communications network and has provided TICOR with the capital infusions necessary for its rapid growth. TICOR is licensed to write insurance in all 50 states from its 27 offices.

American Mortgage Insurance Company. American Mortgage Insurance Company (AMIC) was established in 1961 and is headquartered in Raleigh, North Carolina. The firm is wholly owned by AMIC Corporation of North Carolina, which was purchased recently by Merrill Lynch. The firm is well diversified geographically and writes mortgage insurance in 37 states from its 19 underwriting offices. Its top three and five states account for only 33.7 percent and 45.2 percent of its 1978 premium revenue. AMIC's market share has declined slowly in the past few years, however, from 7.8 percent in 1976 to 7.4 percent in 1978.

PMI Mortgage Insurance Company. PMI was organized in 1972 in San Francisco, California. Shortly thereafter, it became licensed in Arizona and, while its organizational headquarters is in California, all of its income is reported as earned by PMI of Arizona. The firm's founders included Preston Martin, former chairman of the Federal Home Loan Bank Board. PMI found its expansion efforts curtailed by lack of capital and, in order to grow, it arranged its purchase by Allstate Insurance Company, the casualty underwriter. Allstate is, in turn, owned by Sears Roebuck, Inc.

PMI has increased its market share faster in recent years than any other insurer except TICOR. That market share was 4.7 percent in 1976 and grew to a 7.3 percent share in 1978. PMI, much like TICOR, has focused its marketing efforts in California and Texas, two of the fastest growing markets for private mortgage insurance. It is the more concentrated of the two firms, and more than 76 percent of its insurance written in 1978 was generated in 5 states. PMI writes insurance in 41 states and 15 underwriting offices.

Tiger Investors Mortgage Insurance Company. Investors Mortgage Insurance Company (IMI) was incorporated in Illinois in 1968. It became Tiger Investors Mortgage Insurance Company upon its purchase in 1976 by Tiger International. This firm has experienced a slowly diminishing share of the market in recent years, down to 6.4 percent in 1978 from 6.7 percent in 1976. Tiger is well diversified geographically--it wrote only 30.5 percent of its 1978 premiums in its largest 3 states and 43.0 percent in its largest five states. Tiger currently writes insurance in 49 states from its 17 underwriting offices. Tiger Investors Mortgage Insurance Company is headquartered in Boston, Massachusetts.

The Third-Tier Firms

The remaining segment or third tier of the industry includes seven firms that are relative newcomers to the industry. The oldest of these was organized in 1972, and the most recent firm to enter the industry (Commonwealth) was organized as recently as 1976. These firms wrote about 5 percent of the new premiums written during 1978. Much of this included insurance provided to lenders in local or regional markets. The third-tier firms include Republic, Foremost, Home, Commercial, Pamico, Commonwealth, and Integon.

Republic Mortgage Insurance Company. Republic was incorporated in North Carolina in 1972, and is headquartered in Winston-Salem, North Carolina. The firm writes mortgage insurance in 15 states from its six underwriting offices. Republic is the largest of the thirdtier firms and wrote 2.3 percent of total 1978 U.S. direct premiums written. The firm's markets are geographically concentrated: 66 percent of the firm's 1978 premiums were written in Republic's top three state markets. Although Republic is not owned by or affiliated with any other corporation, it recently began merger negotiations with Old Republic, a Chicago-based insurance firm.

Foremost Guaranty Corporation. Foremost was incorporated in Michigan in 1972, and writes mortgage insurance in 21 states from its 14 underwriting offices. Foremost is a wholly owned subsidiary of Foremost Insurance Company, which is the major holding of Foremost Corporation of America. Foremost is headquartered in Madison, Wisconsin, and writes most of its insurance in the central United States. The firm obtains 55.3 percent of its premiums revenues from its largest three state markets and 73.8 percent from its largest five states. In 1978, Foremost wrote 1.5 percent of total premiums written in the United States.

Home Guaranty Insurance Corporation. Home was incorporated in 1972 and writes insurance in eight states from two underwriting offices. The firm is headquartered in Richmond, Virginia, and is fuly owned by HGIC Corporation, a Virginia holding company whose principal asset is Home Guaranty. Home has a 0.5 percent share of 1978 industry premiums and is very concentrated geographicaly: 79.4 percent of its 1978 premiums were written in Virginia.

Commercial Credit Mortgage Insurance Company. Commercial Credit Mortgage Insurance Company (CCMI) was incorporated in 1974 in Maryland and is headquartered in Baltimore. The firm currently writes mortgage insurance in 19 states from its eight underwriting offices. Commercial wrote 64.2 and 78.0 percent of its 1978 premiums in its largest three and five state markets, respectively, and had a 0.4 percent share of the 1978 industry premiums written. Commercial is wholly owned by Cavalier Insurance Company which is wholly owned by Control Data Corporation.

Pennsylvania Mortgage Insurance Company. Pennsylvania Mortgage Insurance Company, called Pamico, was organized in Pennsylvania and is headquartered in Valley Forge, Pennsylvania. The firm is a wholly owned subsidiary of Pennsylvania Thrift Services Corporation, also a Pennsylvania firm. The firm has 0.2 percent of the industry's 1978 premiums written, and is geographically most concentrated in Pennsylvania. In 1978, 99.3 percent of premiums were written within three states. Pamico is the only one of these 14 insurers that is not a member of Mortgage Insurance Companies of America (MICA), and it is the only firm that is explicitly owned by lending institutions.

Commonwealth Mortgage Assurance Company. Commonwealth Mortgage Assurance Company is headquartered in Philadelphia, Pennsylvania, and was incorporated in Pennsylvania in 1976. The firm had a 1 percent share of the 1978 industry premiums written and wrote 89.6 and 98.7 percent of its 1978 premiums in its top three and five states, respectively. Commonwealth writes mortgage insurance in seven states from its six underwriting offices. The company is a wholly owned subsidiary of Commonwealth Land Title Insurance Company which is also a Pennsylvania company.

Integon Mortgage Guaranty Corporation. Integon was incorporated in Georgia in 1972 under the name of Secura Corporation, and was headquartered in Atlanta, Georgia. Secura was subsequently purchased by Integon Corporation, an insurance holding firm which is headquartered in Winston-Salem, North Carolina. Integon, the smallest of the insurers in premiums written, wrote 0.1 percent of the 1978 industry premiums. Integon wrote 93.5 percent and 96.3 percent of its 1978 premiums within its top three and five states, respectively; 80 percent of its 1978 premiums were written in Georgia. The firm writes insurance in 13 states from its three underwriting offices.

THE REGULATORY ENVIRONMENT

The private mortgage insurance industry is subject to little direct federal regulation, but each insurer must fulfill those requirements necessary for licensing by the state in which it is domiciled or operates. That extent of scrutiny or regulation varies significantly across states, and it is only recently that attempts have been made to codify or make more homogeneous, the requirements that are necessary for licensing.

The void that has been created by absent federal regulation or sometimes loose state regulation has, to a considerable degree, been fulfilled by the mortgage insurer approval requirements of such federal agencies as the Bank Board, FNMA, and the Mortgage Corporation. The activities of these regulatory agencies and secondary mortgage market institutions are authorized by federal statutes or charters, and as a result, they are instruments of informal and indirect federal regulation. They often dictate the need for mortgage insurance on all high LTVR loans that are held by savings and loan associations, by credit unions, and by some institutional secondary mortgage market investors. This section describes both federal and state regulations as they impact the private mortgage insurance industry.

FHLBB Requirements

The Federal Home Loan Bank Board is the federal agency responsible for regulating the savings and loan industry. FHLBB monitors all federally chartered savings and loans and those state-chartered savings and loans that are insured by the Federal Savings and Loan Insurance Corporation (FSLIC), a part of the FHLBB.

FHLBB currently requires that all member institutions purchase private mortgage insurance on all home loans they make or hold in which less than a 10 percent down payment is made. Prior to 1970, members were not permitted either to make or hold these loans under any conditions. This insurance must be purchased from an FHLBB-approved insurer. The only alternative which FHLBB members have to insuring these high-ratio loans is to set aside an amount equal to one percent of the unpaid principal until the ratio drops below 90 percent of the original loan amount. Many lenders consider this an unattractive alternative because it reduces their available capital and their ability to extend credit.

The FHLBB also requires that its member institutions limit to 25 percent of total assets their holdings of loans with greater than 90 percent LTVRs. Currently, 50 percent of the mortgage holdings of savings and loans may be in loans greater than 80 percent LTVR. The regulatory changes that permitted savings and loans to hold more high LTVR loans have greatly increased the use of private mortgage insurance by member associations. There are no regulations requiring insurance on the high LTVR loans made or held by mortgage bankers or commercial banks.

Credit union regulations are similar to those for savings and loans. They require private mortgage insurance on mortgages with LTVRs greater than 90 percent until the ratio drops to below that level, regardless of whether the credit union plans to hold or sell the mortgage note.

Regulation by FNMA and FHLMC

Title III of the Emergency Home Finance Act of 1971, known as the Federal Home Loan Mortgage Corporation Act, established the Mortgage Corporation to purchase and sell home mortgages, and also established specific conditions under which it could purchase insured, high LTVR conventional loans. This legislation substantially enlarged the secondary market for such loans and provided a major impetus to the growth of the private mortgage insurance industry. In addition, Title II of this Act amended the charter of the Federal National Mortgage Association to permit the purchase and sale of both insured and uninsured conventional loans. Specifically, the Act forbade the purchase of conventional loans either by FHLMC or FNMA if the unpaid principal balance on the loan was greater than 75 percent (80 percent after 1974) of the purchase price unless:

- the lender retained a participation interest of greater than 10 percent in the mortgage; or

- the lender agreed to repurchase or replace the note upon FNMA's demand if a buyer defaulted; or
- the amount of the unpaid principal balance over 75 percent (80 percent after 1974) of the purchase price was insured by an approved private mortgage insurer.

Mortgage banking firms originated aproximately 81 percent of the loans purchased by FNMA, in 1979. This was a decline from nearly 88 percent in 1977. Mortgage bankers, however, are generally too thinly capitalized to retain a 10 percent equity participation in each loan they sell to FNMA. Their lack of capital similarly makes mortgage bankers unwilling to agree to repurchase or replace loans already sold to FNMA. Consequently, the third alternative, which requires insurance from a qualified mortgage insurer, has been the primary method used to facilitate the sale of high LTVR mortgages to both FNMA and FHLMC.

The major regulations that affect mortgage insurance firms are the conditions that must be met for an insured loan to be eligible for purchase by FNMA and FHLMC. Both organizations prohibit inducement fees (fees paid by the insurer to the lender to attract business), and both require that a mortgage insurer write only mortgage insurance. No more than 10 percent of a firm's insurance in force can cover other than one- to four-family homes. FNMA and FHLMC also require that insurers limit geographic risk by writing no more than 20 percent of their total policies in any one standard metropolitan statistical area (SMSA) and no more than 60 percent of total policies in any one state.

Both FNMA and FHLMC require that an approved mortgage insurer have a minimum of $5 million in capital. FHLMC specifically requires that an insurer's total insurance-in-force may not exceed 25 times its policyholders' surplus. A similar requirement is expressed in Section 3.18 of the Model Act that has been adopted by the National Association of Insurance Commissioners (see Appendix E).

The reasonableness of this $5 million capitalization requirement was challenged in 1975 by Mid-Atlantic Mortgage Insurance, Inc. a small Maryland-based insurer with less than $1 million capital. In 1974 Mid-Atlantic applied for FHLMC approval and was rejected: Mid-Atlantic was then denied a request for reconsideration but was granted a hearing. Mid-Atlantic contended that FHLMC should rely upon state regulation and approve any mortgage insurer licensed in the states in which it transacted business. At the hearing before an officer appointed by the Board of Directors of the Mortgage Corporation, the $5 million capital requirement was found to be reasonable in light of FHLMC's need for stable capital market acceptance for its participation certificates. In addition, the presiding officer found that the FHLMC Act gave FHLMC sufficient authority to establish eligibility requirements as a prerequisite to approving a company as a qualified private mortgage insurer, notwithstanding the fact that states might impose less stringent requirements.

State Regulation

Most of the states group private mortgage insurance in the same category as casualty insurance, and maintain similar rules and regulations that apply to both. The surveillance of mortgage insurance activities, however, represent only a very small market place over which state insurance commissions have jurisdiction, and as a result, the interest in this industry that has been shown by many state insurance commissions has been very limited.

Twenty-one of the states have adopted laws that specifically govern the actions of the private mortgage insurers. In 1976, the NAIC adopted a Model Act patterned after the laws passed in 19 of these states that had written legislation directly governing mortgage insurers. As of this writing, only Kansas and Arizona have approved the Model Act in its entirety, but several more states are currently involved in enacting such legislation.

The Model Act (reprinted in Appendix E), allows private mortgage insurance to be written only on "authorized real estate". This is defined as property in which the certificate of indebtedness does not exceed 95 percent of the property's market value. The maximum coverage called for is 25 percent of the unpaid principal balance. This provision, however, has been waived in several states that allow 30 percent coverage. The Act considers the insurance arrangement to be a risk-sharing one and, in the interest of arm's-length transactions, calls for the insurer to do a reasonable credit check on the borrower before it issues a policy.

The Act places some limits upon a firm's geographic concentration so that its risk is diversified. Insurance on a single project or housing development is limited to 10 percent of a firm's admitted assets, and no insurer may have more than 20 percent of its insurance in force in any one SMSA. To some extent, this might represent a barrier to the development of a new firm, but the Act requires compliance to this provision only after the insurer has been operating for more than three years.

The Model Act places several constraints on a firm's capital structure. It requires that stock insurance companies have paid-in capital of $1 million and a surplus of $1 million, while mutual insurance companies must have a surplus of $2 million in order to commence writing insurance. Both types of firms are then required thereafter to maintain a minimum balance of $500,000 in their policyholders' surplus accounts. Risk/reserve ratios are limited to 25:1 by the Act, as they are by FNMA and FHLMC.

State insurance commission officials are directed to determine their own accounting rules for when to recognize premiums received as earned. The Act requires that 50 percent of earned premiums be set aside for a period of 120 months, to be drawn upon only if losses in a given year exceed 35 percent of premiums earned during that year. Pro rata schedules are to be set up to provide the appropriate reserves for that insurance which is assumed, ceded, or reinsured.

Our discussions with representatives of the state insurance commissioners' offices in each of the sites which were studied in detail, indicated relatively little concern with the operations of the mortgage insurers. Almost all of the states had different minimum paid-in capital and surplus requirements (see Exhibit IV-13) that ranged from as low as $275 thousand up to the $2 million recommended by the Model Act. Often, members of the insurance commissioners' offices indicated that close regulation of the mortgage insurers was the responsibility of the insurance commissioner in the state in which they were domiciled. As a result, most states do little to monitor the compliance or performance of the mortgage insurers on an annual basis.

Each insurer is required to file with the insurance commissioner in each state in which it is licensed, an annual financial statement that describes aggregate operational results, and premiums earned and written on a state-by-state basis. In addition to this, most states require that each insurer follow a specific procedure for implementing changes in premium rates. As Exhibit IV-13 indicates, most of the states within our sample follow a "file and use" method, which requires no approval from the insurance commission to implement a change in premium rate structure. In these states, only notification is required, but such filings are often evaluated to determine whether they are "excessive" or "inadequate". Both California and Colorado are open competition states, which indicates that it is not even necessary for an insurer to file a rate change with the insurance commission. In Texas, mortgage insurance premium rates are set by the state insurance commission and all licensed mortgage insurers are required to comply with these rates.

ROLE OF THE MORTGAGE INSURANCE INDUSTRY IN THE SETTLEMENT PROCESS

The mortgage insurer plays a passive but very influential role in nearly all settlements involving conventional financing where the borrower is unable to make a down payment of 20 percent or more. In an indirect fashion, he has been instrumental in allowing many young and moderate income individuals to become home owners and to participate in the tremendous equity build-up that has occurred during the past decade. Mortgage insurance, however, represents a rather significant part of a borrower's total closing-related expenses. When single, prepaid premium plans are used, or when the borrower makes less than a 10 percent down payment, the mortgage insurance expense payable at settlement becomes even greater.

The mortgage insurer is represented at closing through the agency of the mortgage lender, and he is therefore absent from the actual settlement process. In fact, it is only under very rare conditions that any contact between insurer and mortgagor develops. As a part of the interview process conducted as a background for this report, mortgage insurers were asked to estimate the percentage of conventionally insured mortgagors with whom they had direct contact. None estimated that direct contact with borrowers occurred as much as one percent of the time, and most insurers said that it never happened or happened only when borrowers expressed dissappointment that their loan application was rejected during the insurer's underwriting process. Most mortgagors were described by lenders as being indifferent among mortgage insurers and lacking in understanding of the critical role mortgage insurance played in their ability to secure mortgage financing.

EXHIBIT IV-13

CAPITAL AND RATE CHANGE REQUIREMENTS OF SELECTED STATE INSURANCE COMMISSIONS

STATE	MECHANISM FOR RATE CHANGE	MINIMUM PAID IN CAPITAL & SURPLUS
California	Open Competition	$2.0 Million
Colorado	Open Competition	275,000
District of Columbia	File and Use	600,000
Florida	File and Use	$1.75 Million
Maryland	File and Obtain Approval to Change	250,000
Massachusetts	File and Use	600,000
Missouri	File and Use	800,000
Texas	Rates Fixed by State	300,000
Virginia	File and Use	$2.0 Million
Washington	File and Use	$2.0 Million

SOURCE: PMM&CO. Interviews With State Insurance Commissioners, February 1980.

V. TITLE ASSURANCE

This section presents a detailed description of title assurance services and the typical role of title assurance providers in the settlement process. The section is principally descriptive, function-/or process-oriented. It is limited to the title assurance process, exclusive of the other settlement services discussed in other chapters of Part 1, although many of the providers may supply a package of services including title assurance. Much of the information presented in this section will be based upon our surveys of local settlement service providers in the eight sample sites, together with information from interviews with title insurance underwriters, state regulatory officials, and local and national industry associations.

Title assurance responds to the need of a purchaser of residential property and the lender of the related mortgage to know the exact condition of ownership of the property. This need is met by a search of the public records, generally referred to as a title search, and an evaluation of those records in order to determine the condition of title. A financial guarantee that the title is clear and unencumbered is met by two forms of title assurance: a policy of title insurance, or an attorney's opinion. The structure of these title assurance services is illustrated in Exhibit V-1.

This section describes the demand for these services and the various providers who supply them. It also addresses the various market mechanisms used to supply title assurance, and the regulatory framework of the market. A more detailed analysis of the performance of this market is presented in Chapter XII of this volume, and available alternatives are presented in Volume III.

DESCRIPTION OF TITLE ASSURANCE

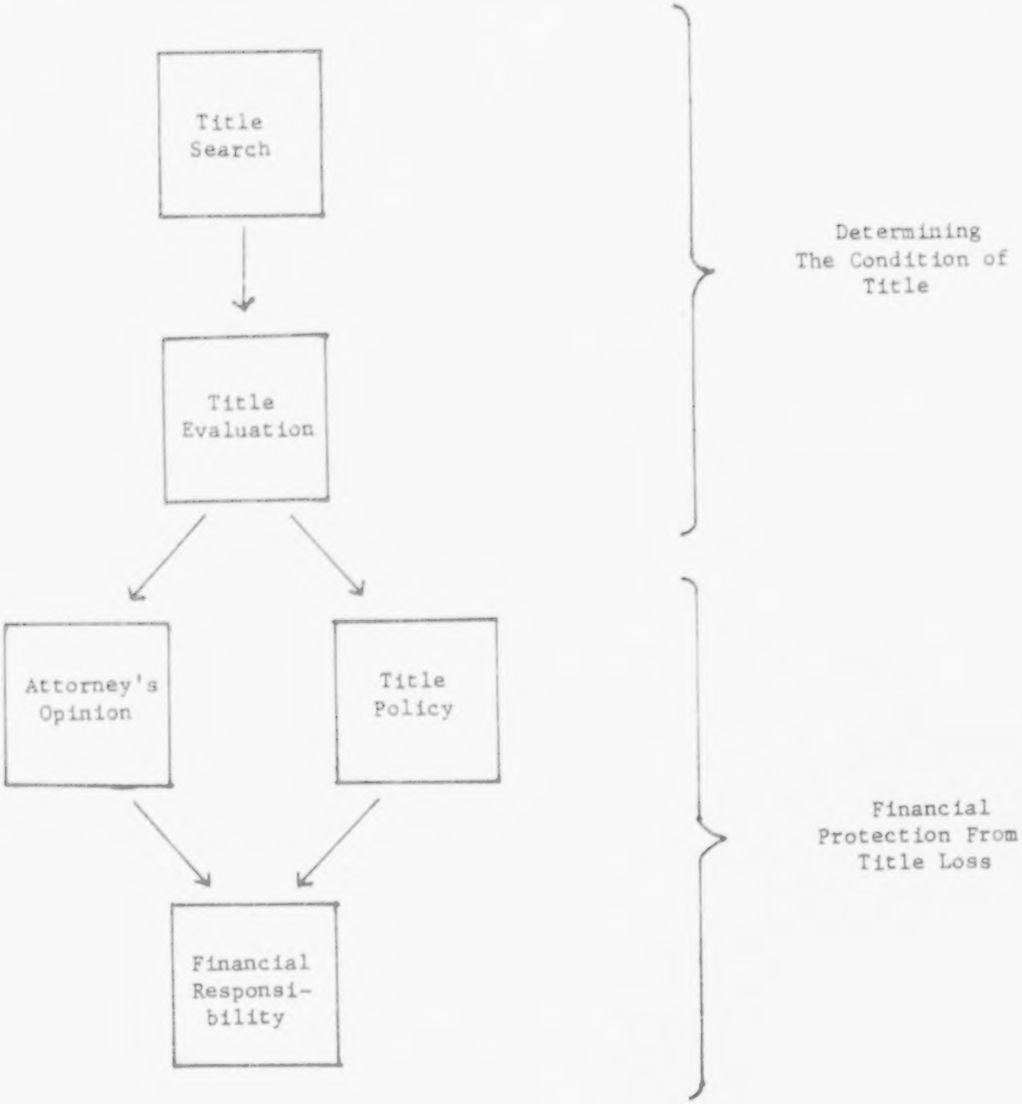
In any real estate transfer, the purchaser needs to be satisfied that the transfer has been completed, and that he will be the rightful owner. Because of the stability and long lasting value of real estate, it is especially suited to act as collateral to lenders, judgment creditors, lien holders, and taxing authorities. These liens will transcend any new ownership. In addition, private property is frequently subjected to public or private easements for utilities, drainage, and roadways which may currently exist or which may be expanded in future use. These possibilities, together with the usually substantial size of the home owner's investment create a need for an assurance that the rights of the home owner in the property are firmly established.

The Demand for Title Assurance

The demand for such an assurance is primarily a result of two basic needs: (1) There is a need to know, in advance and with complete accuracy, the exact condition of the legal title to a particular piece of real estate; and

EXHIBIT V-1

FUNCTIONAL STRUCTURE OF TITLE ASSURANCE SERVICES


Title Search
Title Evaluation
Attorney's Opinion
Title Policy
Financial Responsi-bility
Determining The Condition of Title
Financial Protection From Title Loss

SOURCE: PMM&CO., 1980

(2) If the condition of title is different from that which was reported, there is a need to be protected from any resulting loss. These needs are addressed during the purchase and financing of the real estate. Consequently, the two principal consumers of title assurance services are owners and lenders.

The home owner has a particularly strong interest in both aspects of the assurance obtained. The intangible values normally associated with a family's home are of special importance, and mere financial reimbursement cannot adequately compensate for the loss of that home. And yet, the financial liability aspect of the assurance is also quite important. Most home owners do not have the financial capacity to provide for even minor title losses, and a major loss can completely eliminate the equity that represents a lifetime of earnings. Nevertheless, the demand for title assurance from this source is generally a function of local custom and advice, since the home owner typically does not have the knowledge or expertise necessary to understand or the risks involved.

The demand for title assurance services is determined by the mortgage lending industry which wants the risk of mortgages to be reduced as much as possible. Inaccuracies in determining the condition of a title are costly, time consuming, and subject to delays which increase overhead expenditures and jeopardize investment income. Due to the number of loans originated, the lender has a likelihood of experiencing a title loss at some time. Consequently the lender has a very significant interest in the financial responsibility of the title assurance provider.

The demand of the lenders for title assurance is supported by the secondary mortgage market. As described in earlier chapters, these investors purchase mortgages which may have originated in geographically diverse areas. Thus there is a need for uniform and reliable title assurance protection. Many secondary mortgage market investors have followed the lead of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, who have specified that the necessary assurance must be in the form of title insurance, not an attorney's opinion. Thus, primary mortgage lenders who want a mortgage to be eligible for resale on the secondary market will generally require a title insurance policy.

Whatever the form of title assurance, it serves two basic functions: to determine the condition of title with accuracy; and to provide financial protection in the event of loss.

Determining the Condition of Title

Real estate is a unique commodity, characterized by durability and lasting value which has earned a special treatment in the courts and in society. As a result, the real property laws are quite different from those for personal property. Legal interests in real estate are given special protection, and they are not legally transferred until technically correct procedures have been completed.

But the nature of land is such that many of these legal rights are not readily apparent through the channels of investigation which are available to the typical purchaser. An inspection of the property cannot reveal the existence of a tax lien, mortgage, or a railroad easement. A previous owner may have unknowingly bought the property from someone who did not own it, or who had already sold it, or who signed an improperly prepared deed. These few examples illustrate the problems in the first of the two functions of title assurance, providing a prospective purchaser with notice of the rights of others.

The original type of title assurance was provided in the warranty deed which is used to transfer the legal title of the property to the purchaser. The warranty included in the deed is the warranty of title, where the seller states that the title is free and clear of encumbrances and is held financially responsible for the accuracy of this statement. The first major problem with this assurance is that the seller frequently does not have the expertise, or motive, to ascertain or report the true condition of title. The second major problem is the difficulty of finding the seller in the event of a title loss, obtaining a judgment in a court of law, and collecting that judgment.

During the early part of the nineteenth century the system of recording transfers was developed, in part to resolve many of these problems. Ideally, anyone with a legal interest in a parcel of land would record the documentary source of that interest (such as the deed, mortgage, lien, etc.) in the appropriate public office, and the recorded document would provide notice of that interest to all subsequent purchasers. Thus, a search of the public records would reveal a continuous chain of title showing that all previous owners had correctly conveyed or released their legal rights to the land. After recording became a routine occurrence, conveyancing practice began to include the more traditional forms of title assurance which are based upon a search of the public record.[1]

Two basic functions are associated with determining the condition of title. First, there must be a search of the public records to elicit all of the documents which apply to a particular piece of property. Second, these documents must be evaluated in order to determine the legal interests they represent and to decide which interests currently affect the property. The following discussion describes both of these functions, together with the most common methods used to provide them.

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[1] Lawrence M. Friedman, History of American Law, (New York: Simon and Schuster, Inc., Touchstone Books) 1974.

Title Search

The basic function of a complete title search identifies every document and possible legal interest which is relevant to the title of a particular piece of property. Much of this documentation is centrally located in the county recorder's office, but in some places it is located in other public offices. Property tax information, for example, is usually maintained in a separate tax department. Similarly, while most of the documentation is referenced in one type of index, the title searcher in some counties may have to examine a separate set of indices for different types of documents or for different years.

Many private title assurance providers maintain a duplicate set of records, which are copies of the documents located in the public recorder's office. The provider can then reorganize and re-index the records and can utilize different and advanced technologies, all in an effort to maximize the efficiency of the title search function. This private facility is generally referred to as a "title plant."[1] The obvious benefit of a title plant is to increase the capability of producing a high volume of title searches in a cost-effective manner. Nevertheless, they do require a significant investment and continuous maintenance. Initially only the very high volume found in urban areas prompted the use of title plants, but today they are quite common. In some areas a number of title companies share the expenses and operations of a single plant.

Our survey of eight urban sample sites found that 86 percent of the responding title companies maintained some form of title plant. Interviews with national title insurance underwriters indicated that plants are still more common in metropolitan areas than in rural ones. Similarly, the high volume title insurance and abstracting companies are much more likely to invest in an elaborate title plant than an individual attorney. Some state insurance commissions require a title insurer to keep a title plant, although the facilities in the more rural areas may be considerably less sophisticated than those in metropolitan areas.

The product of a title search depends on the techniques used, but it is designed to make all of the necessary documents and information available to the individual responsible for the evaluation function. Sometimes, this is provided in the form of an abstract, which is simply a collection of the relevant documents. If the same person is responsbile for both the search and evaluation, however, an abstract may be unnecessary, as the documents are made available during the search process. The working paper used in either event is the chain of title. A very simplified example is illustrated in Exhibit V-2. This chain of title will provide some insight into the title search process.

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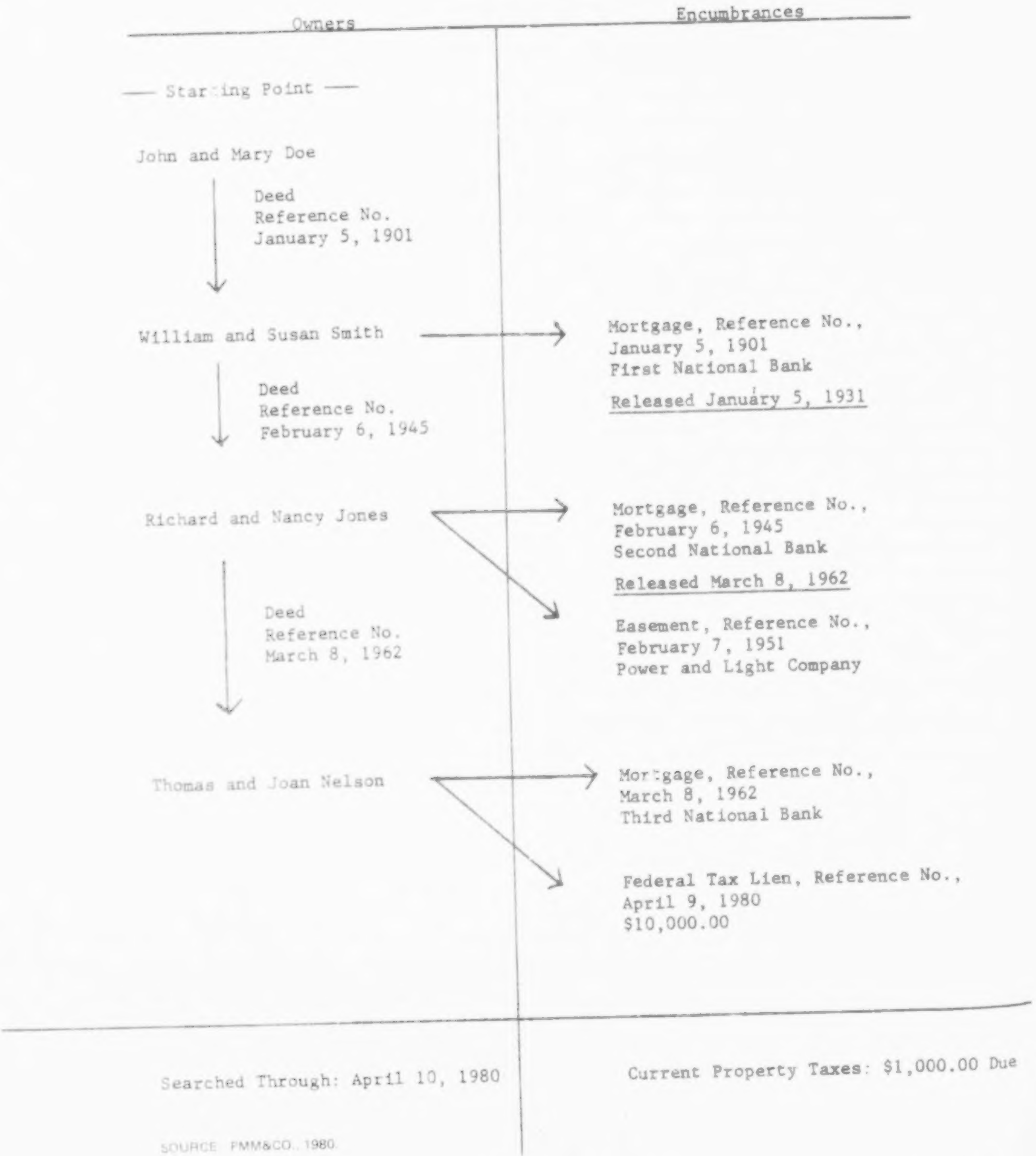
[1] "Title plant" has been used, at times, to describe many different facilities ranging from a file of previous searches to the official county records. In our interviews, however, we found that the term is generally used to refer to a private facility which indexes copies of the public records on a regular basis, normally daily. We will conform to that usage in this report.

EXHIBIT V-2

SIMPLE CHAIN OF TITLE



Owners

Encumbrances

— Starting Point —

John and Mary Doe

Deed
Reference No.
January 5, 1901

William and Susan Smith

Mortgage, Reference No.,
January 5, 1901
First National Bank
Released January 5, 1931

Deed
Reference No.
February 6, 1945

Richard and Nancy Jones

Mortgage, Reference No.,
February 6, 1945
Second National Bank
Released March 8, 1962

Easement, Reference No.,
February 7, 1951
Power and Light Company

Deed
Reference No.
March 8, 1962

Thomas and Joan Nelson

Mortgage, Reference No.,
March 8, 1962
Third National Bank

Federal Tax Lien, Reference No.,
April 9, 1980
$10,000.00

Searched Through: April 10, 1980

Current Property Taxes: $1,000.00 Due

SOURCE: PMM&CO., 1980.

Depending on local circumstances, whoever bears the financial responsibility for the accuracy of the seach may authorize the searcher to begin at a specific starting date under certain situations. For example, once the title to a parcel has been searched and evaluated the first time, there is no need to perform that part of the search again. The search cannot be eliminated entirely, but it can be shortened considerably, especially in the case of a subdivision. This and many other short-cuts, however, enter into the task of evaluation and risk-assumption.

Title Evaluation

The evaluation process is the second critical function in determining the condition of title. Even if documented in an abstract, the title search by itself does not supply any conclusions as to the nature of the title, but only indicates that the reproduced documents are all that are relevant to the subject property. The documents must be examined and evaluated by someone who has the expertise to be able to notice and identify any irregularities, defects, liens, or encumbrances and who can decide whether they actually have a material effect on the seller's title. The examiner then specifies the precise condition of title in a written statement, based upon his or her conclusions. The prospective purchaser's need for an assurance of good title is answered by the written statement and conclusions of an expert, backed up by financial responsiblity in event of a title loss.

As already mentioned, an examiner can save considerable time and money by not duplicating previous work; but there is a tradeoff between accuracy and savings. Just as the examiner must make an informed judgement on that question, similar decisions must be made in the evaluation process. Except in unusual circumstances, there is no reason to stop the sale of a house just because a zealous searcher has discovered a technical defect in an 1821 deed. The examiner makes a reasonable tradeoff between complete, technical accuracy and the expense needed to obtain it. Other judgments are not as simple, but the decision must be made. When the decision is wrong, there is financial responsibility.

Financial Protection from Loss

All providers of title assurance attempt to provide a completely accurate statement of the condition of title; but the different forms of the assurances they provide are distinguishable by the limits of their liability. The two basic forms of title assurance are the attorney's opinion and title insurance. The attorney's opinion may be based upon title search and evaluation provided by a variety of sources, even a title insurance company, but the final product which identifies the extent of liability is the attorney's opinion itself.[1]

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[1] The attorney's opinion is also frequently referred to as a certificate of title, a title opinion, and a number of other different names across the country. By whatever name, the attorney's opinion is that written statement which makes the attorney liable to the purchaser or lender, as it is later described in more detail.

The policy of title insurance may also be based upon services performed by other providers, including attorneys who may act as agents of the insurance company. The form of the assurance defines who is responsible to whom, and with what limitations.

Attorney's Opinion

Since the conclusions of an examiner normally require an evaluation and interpretation of legal rights, title opinions provided by or through consultation with an attorney were the original form of title assurance. The written opinion does ensure that a search of the records was made to determine the condition of title and establishes financial responsibility for any errors that are made in either the search or evaluation. But in 1868, the case of Watson v. Muirhead[1] provided the first real definition, and limitation, of the extent of this liability. The Pennsylvania Supreme Court found that an examiner can be held liable only for negligence in the search or examination. Thus, the legal principles of negligence define the limits of liability incurred under an attorney's opinion.

The standard of care which the principles of negligence impose on an attorney are strict. If an attorney fails to report a properly recorded document, or makes an error in evaluating the relevance of the document, negligence is presumed. But the attorney's liability is restricted to reporting only those defects, liens, and encumbrances which have been properly recorded. Consequently, the attorney is not liable for the title loss: (1) if an easement or tax lien was not properly indexed in the public records; (2) if an estranged husband had his wife's signature forged on a deed; (3) if an unknown heir of a former owner returns to assert his claim. These hidden defects, which are generally referred to as "off-record" risks, also include fraud, duress, impersonation, and lack of legal capacity as well as any easements, liens, and other real property interests, which are allowed by law to exist and run against good faith purchasers even though they are not recorded.

Because the liability under an attorney's opinion is based on negligence, damages may be recovered. The opinion generally binds the law firm, if one is involved, and any malpractice insurance carriers that have an active policy in force. Nevertheless, the nature of the legal responsibility makes it subject to finding the attorney or other liable party, obtaining a judgment, and collecting on it. Lenders have frequently addressed this problem by specifying that they will only accept an attorney's opinion from a law firm which meets various subjective criteria such as experience, stability, and adequate malpractice insurance. The typical purchaser, especially one who is new to an area, cannot readily determine which firms are stable and insured or are responsive to the needs of home owners as well as lenders.

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[1] Watson v. Muirhead, 57 Pa. 161 (1868).

Title Insurance

Following the decision in Watson v. Muirhead limiting the liabilities under an opinion of title, the Pennsylvania legislature passed an act allowing the incorporation of title insurance companies. In 1876, the first title insurance company was founded in Philadelphia to provide financial protection against the types of losses which are not covered by an attorney's opinion.[1] Obviously, the liability of the insurance company is defined by the terms of the policy, but the major terms of coverage have been generally standardized into the nationally accepted American Land Title Association policies.[2] Basically, the policy of title insurance provides protection against any title defect. The limitations are the exceptions to coverage which are listed in the policy. There are two basic forms of title insurance which, although provided at the same time and based upon the same title search information, vary to a degree in their terms of coverage. Therefore, the lenders and owners policies will be described separately.

Clearly, the policy of title insurance is more than a guarantee that the title search and examination were done correctly. The insurance company is financially responsible for any loss resulting from a defect in title, including most of the "off-record" losses mentioned previously. The owner's policy, however, generally lists a number of exclusions from coverage. These exclusions are consistent with the primary function of title assurance, that of providing a prospective purchaser with notice of the rights of others. Not surprisingly then, the insurer is not responsible for losses resulting from any claim of which the purchaser was, in fact aware at the time of purchase. Similarly, items which would be discovered through other customary procedures that are readily available to the purchaser, such as a survey or an inspection of the premises, are also excluded. The last major group of exceptions excludes from coverage easements and liens that have not been recorded. These are the only "off-record" losses not generally covered, and can frequently be costly to home buyers, expecially buyers of new homes. In some places, workers have as long as six months to file mechanics liens. Thus, home buyers can and do find they must pay for work performed prior to the transfer of ownership. This exclusion may be in response to the industry's perception of the comparatively high frequency and severity of unrecorded, and yet valid and enforceable mechanics' liens.

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[1] It may be of some significance to note that the first policy of title insurance was a mortgagee's policy, protecting only the interests of the lender.

[2] Although in some states the approved minimum policies do not provide as much protection as the standard ALTA policies, and some companies have added extra protection, the basic coverage is quite similar--for the purposes of this study--wherever it is available.

The policy of title insurance requires the insurer to bear the expenses of defending the owner's property from a covered title loss, but the liability for reimbursement is limited to the face value of the policy, which is the original purchase price of the house. Given the effects of inflation, this limitation could prove disastrous in the comparatively rare event of a complete title loss. Some companies have responded by providing a limited inflation rider, which expands the upper limit with the value of the house. However, there is generally an upper limit to this additional coverage as well.

The lender's title insurance policy clearly provides the broadest degree of coverage. Since many of the ultimate beneficiaries of lender's title insurance are investors in the secondary mortgage market who are not present at the time of loan origination, they are not in a position to perform even a rudimentary inspection of the premises to protect their interests. The need for fungibility in the mortgage market in order to attract distant, risk-averse investors has been aided by the lender's policy, which the title company will generally provide without exclusions.[1]

It is important to note that even though the purchaser may be required by the lender to pay for the lender's policy, the owner receives no coverage unless an owner's policy is also purchased, at an additional costs. The insurer's liability under a lender's policy is limited to the outstanding balance due on the loan, and no amounts are paid unless the lender's collateral security in the property is threatened by the title loss. Therefore, the buyer with no owner's policy could be required to pay a relatively large claim provided that the amount of the loss was no larger than the equity in the property.

The demand for title assurance is met by a wide variety of individual providers in two ways. Both the attorney's opinion and title insurance provide a type of financial protection from loss. The diversity in the services actually supplied is a result of varying local practices and the professional capabilities of the individuals who are involved. Because of the infrequent nature of title defects, an effective evaluation of these providers can only be made over a long period of time. The typical purchaser, especially one who has only recently moved into the immediate locality, is generally incapable of making a truly informed decision as to which provider might best be able to respond to his needs.

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[1] A title company asked to provide a lender's policy without exceptions will typically require the purchaser or seller to provide additional documents, such as: a survey; waivers of mechanics liens; and affidavits relating to possession and home improvement construction. They have not commonly written owner's policies with no exceptions.

PROVIDER FIRMS

The various steps necessary to accurately determine the condition of title and provide adequate financial protection from title loss are performed by three distinct types of providers: abstracters; title companies; and attorneys. This section addresses the roles which each type of provider takes in the title assurance process, the structure and characteristics of the primary providers, and the interrelationships among the participants in their various capacities.

Abstracters

In the early stages of the title assurance industry, growth in urban areas made it difficult--and costly--for attorneys to conduct all the necessary title searches. They found a need for experienced individuals who were familiar with the local procedures and with the techniques involved to perform searches for them on a volume basis. As early as the 1840s, law firms in large eastern cities had hired independent abstracters to perform this function. Eventually, abstract companies developed. These firms were the first private concerns to create title plants and economy of scale efficiencies.

Today, abstract companies and independent "free-lance" abstracters still provide title searches to attorneys on a regular basis. Their function is limited primarily to collecting the papers that document the results of a title search. The search is accompanied by a certificate stating that the abstract includes all of the recorded documents that are relevant to the title of a particular piece of property. The abstract is then examined and evaluated in a law firm, which produces an opinion of title. In areas where this combination of efforts is still used, the attorney's liability may be limited to errors in the evaluation of the documents, and any losses resulting from an error in the title search must be recovered from the abstracter.

Many abstract companies have expanded their role in the title assurance process to include the evaluation of title. Although these firms may still be incorporated as abstract companies, the activities they now perform bring them into the functional category of title company--either as underwriter or agent --and are treated as such in this study. Because of the singular function of the abstracters, however, and their minor role in the settlement process in most parts of the country, a detailed treatment of this industry falls outside of the scope of this study.

Title Companies

Underwriter title insurance companies are those companies which are directly liable under a policy of title insurance. This feature distinguishes them from their agents, who may actually conduct the search, evaluate title, and write the policies, and who may even be liable to the underwriter for a portion of losses incurred, but who are not liable under the policies themselves. Since the underwriters bear the financial risk, they also set the standards for title evaluation and administer the authority to issue title policies. And since they have a strong interest in limiting their losses by improving the accuracy of the search and evaluation, they provide substantial direction, training, and assistance to both branches and agents. They are, however, the sole providers of title insurance financial responsibility.

Underwriters may also provide title searches, perform evaluations, and write policies. Sometimes, small underwriters may sell directly to the customer from their home office, but normally even the moderate-sized underwriter performs these functions through branch offices. Many large underwriters operate on a nationwide basis and maintain branch offices in virtually every state.[1]

Many underwriters also supply title insurance through two types of agents, the underwritten title company and the attorney-agent. The underwriters are careful to distinguish between these two classes, because the services actually peformed by each may vary and the amount of compensation to the agent may also differ. The agents are responsible for determining the condition of title, and they sell the policies of one or more underwriters. It is important to note that the agents are free to negotiate the agency relationship with any number of underwriters.[2] The competition among underwriters for these agents is high, because sales generated through agents increase revenues and market share without the major investment needed to open a branch, and generally without the daily expenses associated with producing the title search and final policy.

Agents are compensated for their services by retaining a percentage of the premiums received on behalf of the underwriter, as illustrated in Exhibit V-3. Depending generally on local custom, they may charge additional fees for some of the services performed in producing the policy. But in some areas, the percentage of premium is their single source of settlement-related revenue. This method of compensation is invariant. Our surveys of local title insurance

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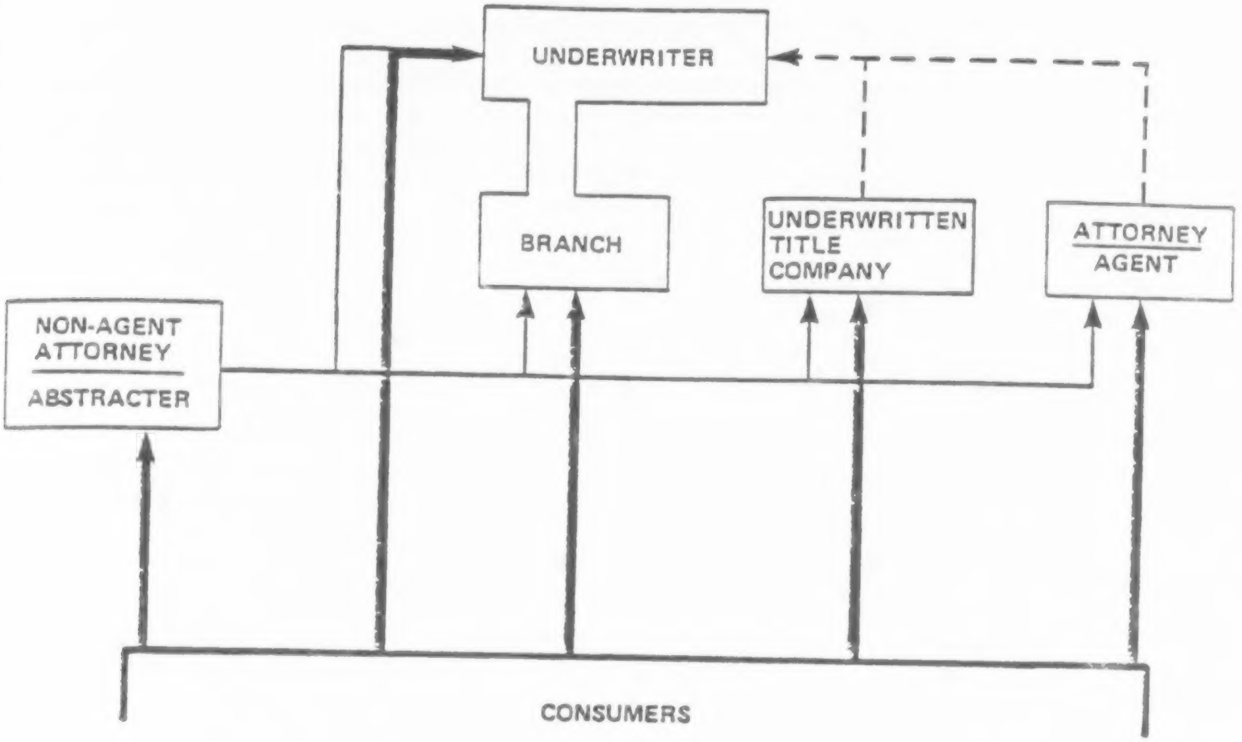
[1] Title insurance companies are not authorized to do business in Iowa. They may write a title policy which protects the title to land located in Iowa, but a policy-writing branch office cannot be operated in the state.

[2] There are, however, some corporate agencies which are wholly or partially owned subsidiaries of the underwriter who, of course, sells only the policies of the parent. Despite the technical agency relationship, these are functional equivalents of the more traditional branch office.

EXHIBIT V-3

CONSUMER FUNDS PAID FOR TITLE INSURANCE


UNDERWRITER
BRANCH
UNDERWRITTEN TITLE COMPANY
ATTORNEY
AGENT
NON-AGENT ATTORNEY
ABSTRACTER
CONSUMERS

━━━➤ Total funds paid to the listed provider, including premium paid for title insurance policy, and charge, if any, for title search.

⟶ Premiums paid to the selected title insurance provider by non-agent attorneys and abstracters that are not affiliated with an underwriter.

- - -➤ Premiums, less commissions, paid to underwriter by the Underwritten Title Company or attorney agent.

SOURCE: PMM&CO., 1980

providers and attorneys, and our interviews with underwriters established that this is the only form of direct compensation from the underwriter to the agent.[1] It also established that this commission rate is a primary competitive tool used by underwriters to keep and attract their agents.

Underwriters generally do not set just one standard rate which is paid to all of their agents. Instead, the rates tend to vary among individual agents, and by locale. This variation results from a number of factors. Local custom and the commissions allowed in the past play an important part in determining the figure. Some states, such as Texas, specify the range of premium splits which will be paid to the agents. Generally, within the local range the commission is determined, to a large extent, by the volume of business and productivity of the individual agent.

The corporate form of agency is generally referred to as an underwritten title company (UTC). Although the underwriter and UTC are completely separate and functionally different, they are generally indistinguishable to the consumer of settlement services.[2] UTCs own title plants, conduct title searches, evaluate titles, and write the policies of title insurance. They are the first recipient of claims and often make minor title loss reimbursements themselves. Even though they are free to negotiate contracts with several underwriters, they usually write the policies of only one underwriter.

Our survey disclosed that the commissions to UTCs vary considerably. Responding UTCs reported percentages ranging from 30 percent to 85 percent. Interviews with national underwriters indicated that some of the agencies, primarily in the California markets, retain as much as 92 percent of premium. However, in the cases in which a large percentage of the premium is retained, the premium is usually defined to included the cost of a title search. At other times, the premium refers to the "risk" or insurance premium. Sometimes the UTC assumes an increasing portion of the financial responsibility for losses, including those from off-record risks as its retention of premiums increases. The underwriter is still the entity which is directly liable to the insured, but the UTC's agency agreement requires the UTC to pay an often significant portion of all covered losses.

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[1] Indirect compensation of agents, through promotional and incentive programs, were not found to be common, nor did they represent a significant portion of agent income.

[2] Both UTCs and underwriter branch offices are corporate sellers of title insurance, falling into the generally-perceived generic category of "title company." It is a rather subtle distinction that UTCs generally do not have the words "insurance" or "guaranty" in their name.

Attorneys

Because of the legal nature of the process of determining the condition of title, attorneys historically have played a major role in the title assurance industry. In different areas of the country, atttorneys provide a variety of title assurance functions and supply such assurance either by issuing a title insurance policy, attorney's opinion, or both. The title search may be obtained from a title company, abstract company, or "free-lance" abstracter, or it may be performed by paralegals or staff of the law firm.[1] Similarly, the evaluation may be performed by the title company or may be performed by paralegals, staff, or an individual attorney. Attorneys have three distinct roles in the system for providing title assurance: as an attorney-agent, as an approved attorney, and as a provider of attorney's opnions.

The second type of agent for the underwriter is the attorney who may perform a variety of functions and is responsible for writing the policies of one or more underwriters. Whether this role is assumed by an individual attorney or a law firm, and whether an attorney, paralegal or staff actually performs the particular function, this provider is collectively referred to as an attorney-agent. The attorney-agent may perform any one, or all, of the tasks necessary to provide title insurance. Some attorney-agents conduct the search, evaluate title, and write the policy. Some of the underwriters reported that there are attorney-agents who do not perform any of these services, and yet they are still compensated as agents. In some of these instances, the attorney-agent does actually sign the prepared policy, but it was reported that some do not even do that.

Our survey of local attorneys, supported by the interviews with the underwriters, indicate that the commissions on premiums paid to attorney-agents are somewhat lower than those paid to UTCs. Usually the commission is a percentage of risk premium and the attorney is compensated for the search and evaluation. Responding attorneys reported percentages ranging from 25 percent to 60 percent. Within that range, more than half the attorney-agents quoted a rate of 50 percent. The typical attorney-agent does not generate the same volume of business that a UTC does. Also, attorney-agents are less likely than UTCs to rely upon the commission as their sole source of settlement-related income. Finally, attorneys apparently have not desired to enter into the type of shared-loss program that supports the larger UTC retention percentages. Otherwise, the attorney-agent's compensation is subject to the same local customs and individual negotiation that characterizes UTC income.

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[1] Rarely do attorneys conduct the title search themselves except in rural areas.

An approved attorney is not an agent, and does not write the policy of title insurance, but the underwriter has formally acknowledged a willingness to accept the approved attorney's title opinion and will write a policy of title insurance based on its contents.[1] The approved attorney supplies the title opinion to the underwriter, who then supplies the title policy. The underwriter receives the full amount of the premium, and the attorney does not retain any part of it. The attorney is compensated by charging the client for the title opinion, the title search, or some other services. This arrangement provides the non-agent attorney with the opportunity to supply a client with a title insurance policy as a supplement to the attorney's other services. It is relatively uncommon in areas that do not prohibit attorney'agents, since attorneys who concentrate on real estate work in which title insurance is used normally can and do become agents.

Apart from their roles in the provision of title insurance, attorneys can also supply an assurance of title in the form of an attorney's opinion. They are, of course, the sole provider of this type of assurance which predominates in many areas of the country especially in many rural areas. In our study, attorney opinions were common only in Boston. Again, the title search may be obtained from outside sources, or performed in-house. However the condition of title is determined, the attorney signs the written title opinion and is responsible for its accuracy. Compensation for this form of title assurance is paid directly to the attorney or law firm as a fee for services.

Bar-Related Funds

One form of underwriter is unique. In some states, members of the bar have grouped together to form a "bar-related fund" which issues policies of title insurance effectively identical to those issued by the more traditional, privately incorporated underwriters.

Since 1947, nine bar-related title insurance companies have been formed.[2] Florida attorneys organized the first bar fund as a common law business trust to issue title insurance policies through its member attorneys. Now active in 26 states, most other funds have adopted the corporate form of organization and restrict share ownership to attorneys. Unlike the traditional underwriters, bar funds are owned and operated by member attorneys. Typically, a subscribing member pays a small initial fee upon joining. Member attorneys issue policies that are then underwritten by the fund. Income is generated by premiums received from clients when policies are written. A reserve fund that will compensate a client in the event of an insured loss exists just as it does in a commercial title insurance company.

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[1] Technically, many attorney-agents are also approved attorneys. The agency status is an addition to approved status. For the purposes of this study, however, we will use the term "approved attorney" to describe only those who are not agents.

[2] ABA Standing Committee on Lawyers Title Guaranty Funds, How-To-Do-It: Bar-Related Title Assuring Organizations (1976), pp. 5-7.

Functionally, member attorneys perform the same tasks as an underwriter's agent, and the funds supply the same types of services as a traditional underwriter. The system of contributions provides basically the same type of compensation system as the traditional retention of underwriter premiums. However, there is one significant difference from the traditional compensation structure. The member attorneys must pay an initial fee which gives them an ownership interest in the fund, and they share in the profits of the fund. In a few cases the attorney's share bears a direct relationship to the amount of insurance sold, and to the amount of losses paid on the policies the attorney wrote.

In our study, bar-related funds operated in three sites, Jacksonville, Fla.; Denver, Col.; and St. Louis, Mo. The only fund that regularly paid dividends to its members was the Florida Fund. The other two corporations were very small. One had never paid any dividends. The other paid only minimal amounts which were not based on attorney participation. The staff members of the bar-related funds indicated that they saw their function as providing information and aid to their members on an individual case basis. They all had staff members whose function was to answer any questions members might have on all aspects of a particular policy.

Trends in Provider Forms

Title insurance revenues have increased sharply in recent years. The revenue information contained in Exhibit V-4, which has been compiled from industry sources, shows that 1978 industry revenues exceed 1.2 billion--almost twice as large as 1973 revenues, and quadruple those of 1970. A portion of this increase is due to the pricing structure for title insurance, which causes industry revenues to be a function of the price of housing and the rate of housing sales. Thus, the revenues are directly related to the performance of the housing market.

Not surprisingly, then, underwriters who were interviewed indicated a desire to have branch offices when the housing market is doing well and revenues are up, and to have agents when the housing market and revenues slump. The substantial investment and years required to open a productive branch office generally prevent the underwriters from changing forms to take advantage of short-term fluctuations in the housing and title insurance markets. Nevertheless, there does appear to be a fairly long-term trend toward branches and away from agents. This trend may result from any number of causes. Large amounts of capital are necessary to take advantage of technological advances in title plants and forms preparations. Also, there might be a long-term increase in the use of title insurance as opposed to attorney opinions as a form of title assurance.

EXHIBIT V-4

OPERATING REVENUES FOR THE TITLE INSURANCE INDUSTRY

Year	Operating Revenues Current Dollars[a] (000,000)	Comparative Index Current Dollars 1970 = 100%	Operating Revenues Constant (1972) Dollars[b] (000,000)	Comparative Index Constant Dollars 1970 = 100%
1970	$ 323	100.0	547	100.0
1971	453	140.2	566	103.5
1972	556	172.1	556	101.6
1973	621	192.3	582	106.4
1974	582	180.2	655	119.7
1975	590	182.7	710	129.8
1976	776	240.2	706	129.1
1977	1,019	315.5	687	125.6
1978	$1,205	373.1	692	126.5

Sources:

a. American Land Title Association Research Committee, Eleventh Annual Report on Financial Data Received From Underwriting Companies, pp. 7-8.

b. Constant dollars are deflated through use of the annual Gross Private Domestic Fixed Residential Investment in current dollars, as reported by the U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, January 1980.

The latter possibility is suggested by the figures in Exhibit V-4, in which industry revenues have been adjusted for inflation and market performance. These figures show that the ratio of revenues to Gross Residential Investment[1] has shown a marked increase since 1970. Whether this trend represents a moving away from the use of attorney's opinion or a straightforward increase in the use of title insurance is beyond the scope of this study.

MARKET MECHANISMS

The combination of providers who perform the tasks necessary to supply an assurance of clear title varies considerably across the country. Consequently, the types of assurance and the pricing structures and techniques for marketing and selecting the individual provider also vary widely. This subsection describes the typical form that these marketing mechanisms take. A more detailed report of findings related to these mechanisms is contained in Chapter XII of this volume.

Provision of Services

The three tasks necessary to determine accurately the condition of title and provide financial protection from title loss are performed by the different providers in a variety of roles. Conceptually, all of these tasks can be performed by a single provider. Similarly, by combining different providers at successive stages of the process, it is possible to generate a large number of provider combinations in the title process. As a practical matter, only a small number of these combinations are actually found in the marketplace. The three primary mechanisms for the marketing of title assurance are:

- title insurance, through branches, UTCs and attorney-agents;
- attorney's opinion, based on a title search by an abstract company; and
- attorney's opinion, based on a title search by the law firm.

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[1] The figures in Exhibit V-4 represent gross industry revenues in current dollars deflated in comparison to Gross Private Domestic Fixed Residential Investment (as provided by the U.S. Bureau of Economic Analysis) in current dollars. This comparison provides the most accurate deflator for title insurance revenues, as it reflects both the current price of real estate and the rate of turnover, and therefore provides the best index of the potential size of the title assurance market.

Certain of these combinations predominate in different areas of the country. Exhibit V-5 illustrates the mechanisms which are typically used in each state. In those states that show more than one mechanism, there are often significant differences from county to county. Changes in the predominant patterns of title assurance are very slow, due to the fact that a provider usually requires many years of local experience to be able to provide an accurate determination of the condition of title and to establish a reputation in the community for such quality workmanship.

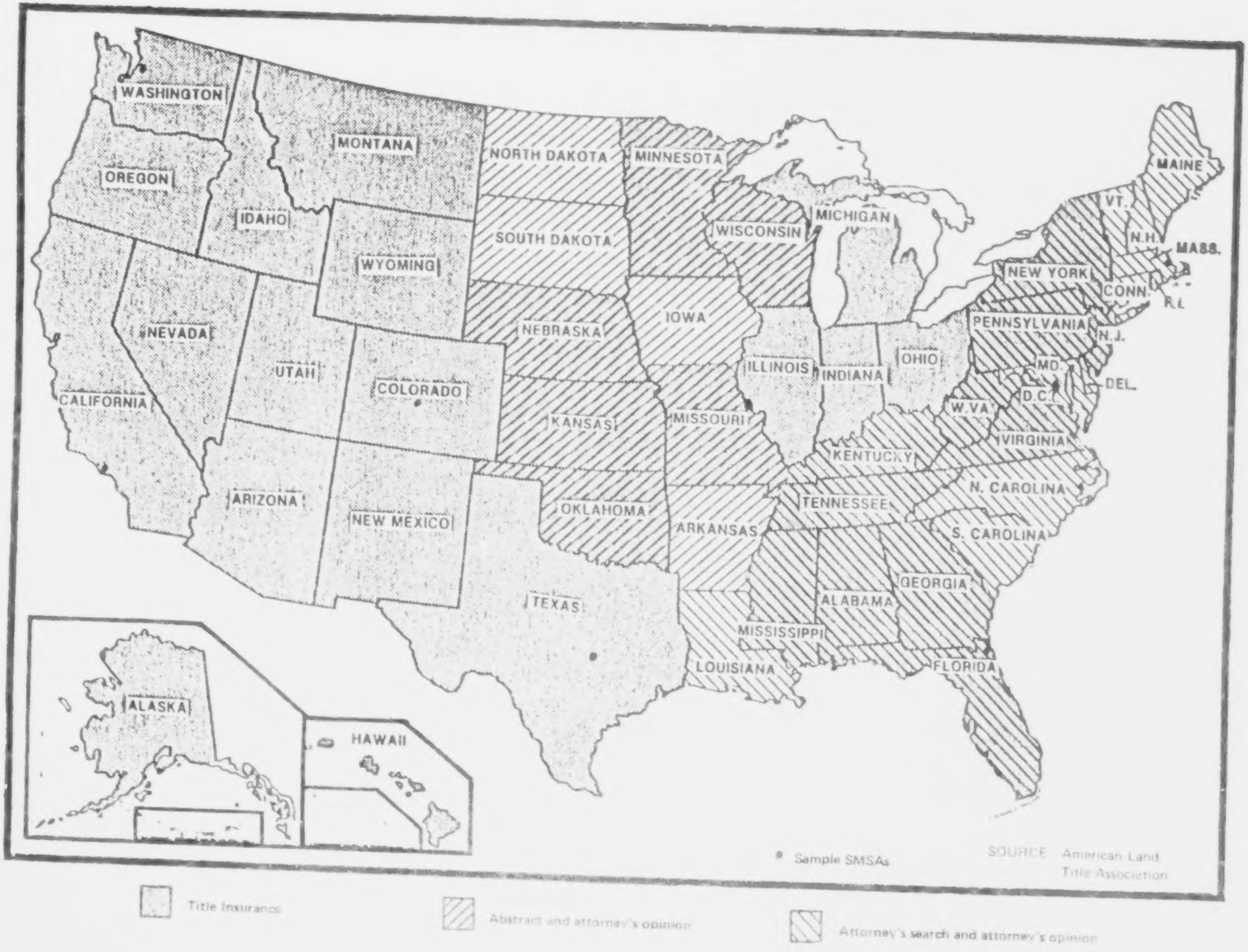
The patterns of title assurance used in each of the selected sample sites, shown in Exhibit V-5 were reflected not only in the survey responses, but also in the availability of applicable providers. For example, attorneys' opinions are almost the only form of assurance used in Boston, and we were unable to complete formal interviews with any title companies in that SMSA. In Denver and Los Angeles, where attorneys are not generally involved in providing either title assurance or closing services, we successfully completed only one and four interviews, respectively, of attorneys who were sufficiently involved in the settlement process.

The general pricing mechanisms used to purchase the various title assurance services vary widely among states, and often within states. Portions of the pricing structures related to title insurance are sometimes set or agreed upon through state regulation or industry rating bureaus. The pricing structures for attorneys' legal services, which include the attorney's opinion, cannot be set or suggested by local bar associations, and regulators generally do not limit or interfere with an individual attorney's or law firm's right to establish its own fee schedules. Typically, however, the final price paid for the complete package of title assurance and other closing services is a product of local practices and the customary fees which have been charged in the past. The final prices for title assurance are invariably tied to the amount of potential financial liability incurred, which is generally equal to the price of the house or mortgage. In general, however, neither operating expenses nor losses to title insurers are closely related to house prices. This issue will be discussed further in Chapter XII.

In many areas, it has become the customary practice to have a schedule of prices for the entire package of services necessary to produce the title assurance, and including most of the other closing services normally performed by that type of provider. The extreme example of this is in Texas, where the price of title insurance set by the insurance commission, represents the pricing structure for all title insurance and closing services as a single package, exclusive only of document preparation and a comparatively nominal escrow fee. Many state insurance commissions have adopted this concept of the "all-inclusive rate," although they differ in the method of determining the rate.

EXHIBIT V-5

PRIMARY MECHANISMS FOR PROVIDING TITLE ASSURANCE


WASHINGTON
OREGON
CALIFORNIA
NEVADA
IDAHO
MONTANA
WYOMING
UTAH
COLORADO
ARIZONA
NEW MEXICO
NORTH DAKOTA
SOUTH DAKOTA
NEBRASKA
KANSAS
OKLAHOMA
TEXAS
MINNESOTA
IOWA
MISSOURI
ARKANSAS
LOUISIANA
WISCONSIN
ILLINOIS
MICHIGAN
INDIANA
OHIO
KENTUCKY
TENNESSEE
MISSISSIPPI
ALABAMA
GEORGIA
FLORIDA
S. CAROLINA
N. CAROLINA
VIRGINIA
W.VA
MD.
D.C.
DEL.
PENNSYLVANIA
N.J.
NEW YORK
CONN.
R.I.
MASS.
VT.
N.H.
MAINE
ALASKA
HAWAII
● Sample SMSAs
Title Insurance
Abstract and attorney's opinion
Attorney's search and attorney's opinion

SOURCE: American Land Title Association

In most areas, the pricing of title assurance services is fragmented into the different functions performed. Separate fees can be charged for the title search, title evaluation, and title insurance, as well as for other closing services. This is typically evident when the functions are performed by different providers, but it also happens even when one provider supplies all of the services. It is even possible that different providers, and/or different forms of title assurance will attract different pricing mechanisms in the same area, so that the choice of provider or form may result in either a package or fragmented rate. As mentioned, however, the pricing mechanism is usually related to historical local practices, and both mechanism and amount are generally similar within a particular community. Our findings and analysis of the comparative prices actually charged for title assurance services are contained in Chapter XII of this volume.

Referrals

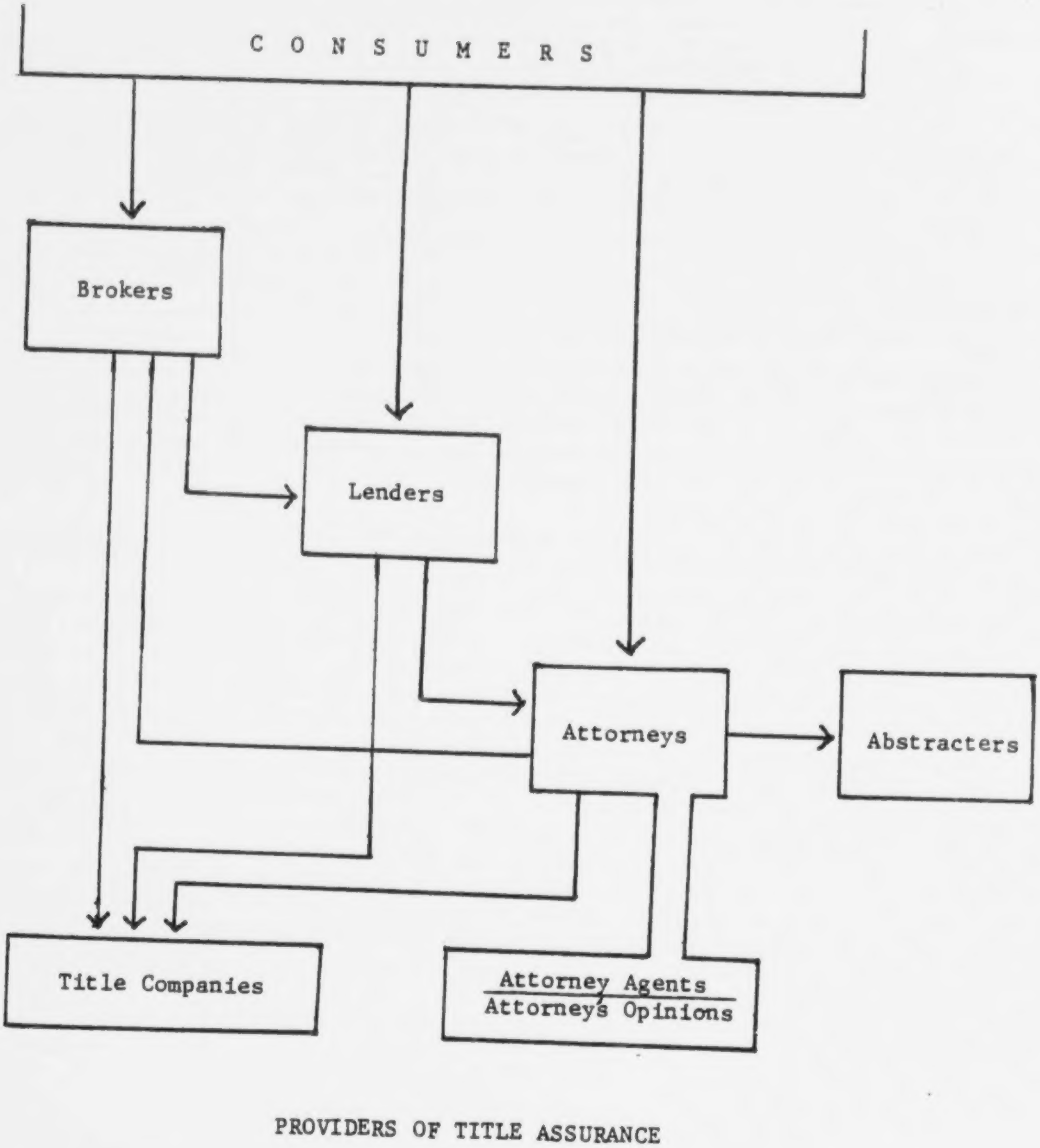
Because of the specialized nature of title assurance services, the extraordinarily long turnaround between poor workmanship and title losses, and the wide range of workmanship exhibited by individual title assurance providers, the typical seller or purchaser of residential property is ill-equipped to make an informed choice concerning either providers or forms. The providers of other real estate and settlement services, on the other hand, are in a special position to observe individual title assurance providers over a long period of time and to effectively evaluate the quality of the services with an understanding of local standards, general real estate principles, and consumer needs. Obviously, the consumer has a need for advice and direction in this choice, and these other providers who have personal contact with the consumer are in the best position to respond to that need by referring the customer's business to the various title assurance providers.

The systems for making these and other referrals, along with the types of providers involved, is illustrated in Exhibit V-6. Naturally, these mechanisms vary by local practice and by which provider has the necessary personal contact with the consumer, but our survey of local providers in the selected sample sites does indicate a number of trends.

As shown in the table in Exhibit V-7, responding title companies indicated that the real estate brokers (and agents) provide the largest source of referrals. The more detailed analysis of SMSAs shows that this trend is exhibited in most of the sample sites. Lenders and attorneys provide referrals in varying degrees. The case of lender referrals is unique, since lenders are also consumers of title assurance. Because of their direct interest in the assurance, and because they have historically perceived a special need--and capability--to select a title assurance provider who

EXHIBIT V-6

TYPICAL REFERRAL MECHANISMS


CONSUMERS
Brokers
Lenders
Attorneys
Abstracters
Title Companies
Attorney Agents
Attorney's Opinions
PROVIDERS OF TITLE ASSURANCE

SOURCE: PMM&CO., 1980.

EXHIBIT V-7

SOURCE OF REFERRALS, AS A PERCENTAGE OF TITLE INSURANCE BUSINESS (1)

	DIRECT CONTACT CUSTOMER (2)	TOTAL REFERRALS	BROKERS	LENDERS	ATTORNEYS	TOTAL
Entire Survey	18%	82%	49%	16%	17%	100%
Washington, D.C.	23	77	36	3	38	100
Jacksonville	16	84	18	27	39	100
San Antonio	18	82	62	4	16	100
St. Louis	19	81	62	10	9	100
Denver	10	90	70	15	5	100
Los Angeles	15	85	62	22	1	100
Seattle	22	78	32	41	5	100

(1) PMM Title Insurer Survey, February 1980. The Boston SMSA was not represented in title insurance interview because of the predominant use of attorney opinions, as explained in the text.

(2) May be buyer or seller.

has a reputation for accuracy and financial responsibility, about a quarter[1] of the responding title insurers indicated that the lender specified the use of their particular company. Forty percent of responding lenders indicated that they specify or recommend the use of particular title assurance providers, usually attorneys.

The nature of these referral mechanisms is apparent to the providers of title assurance services, and the competition for these referrals is intense. This type of competition, referred to as "reverse competition" in Chapter VIII, leads the referring providers to evaluate and choose the title assurer on the basis of criteria which go beyond the basic components of title assurance -- accuracy and financial responsibilty. Some of these additional criteria may benefit the home buyer, such as speed, claims service, or a willingness to accept financial responsibility for title defects which are discovered but unresolved; others such as kickbacks and referral fees may not. Because lenders act as both referrer and consumer, title assurance service sometimes responds to the lenders' needs without providing the same protection for owners, as is most readily apparent in the varying terms of title insurance coverage.

Similarly, the incentive exists to establish a formal system of direct compensation in return for referrals. The economic inequities in many forms of such compensation have prompted an array of legislation designed to control them. This report will examine elsewhere the effects of reverse competition, the forms which it takes, and the effectiveness of legislation to control it.

REGULATORY ENVIRONMENT

The regulation of title assurance activities plays an increasing role in the settlement process. Specific activities that historically have been provisions of title assurance may be prohibited, and new procedures may be required; some state regulators have undertaken to establish uniform rates, as well as influence the structure of the industry. Despite all of this, the actual effect of regulation on the industry may still be essentially slight. A former California insurance commissioner, for example, has commented that the title insurance industry operates "in a regulatory vacuum." Certainly the effect of regulation is directly related to enforcement. The enforcement of different laws in different areas varies widely. However, since the purpose of this study is to evaluate and recommend such attempts, they will be analyzed in greater detail throughout the report. This subsection describes the basic regulatory environment of the title assurance industry.

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[1] PMM&Co. Title Insurer Survey; February 1980; specifically, 23.73 percent.

Federal Regulation

The title assurance industry is afforded special status under federal regulation, since it is treated primarily as a business of insurance--like life and casualty insurance--while the services performed are considered to be ancillary activities. As such, it is exempt from federal antitrust regulation by the McCarren-Ferguson Act. However, federal antitrust regulation has been held to prevent the legal profession from engaging in price-setting for legal and settlement services.[1] This prohibition applies both to performing title searches and to supplying an attorney's opinion. There is a subtle legal distinction between regulating these activities when they are performed by attorneys and exempting the same activities by a title company. There appears to be no economic rationale for such a distinction.

State Regulation

The McCarren-Ferguson Act gives the states priority over federal regulation of the business of insurance. Consequently, although the title insurance industry may be protected from federal antitrust regulation, it may be subject to state antitrust laws. Many states have acts similar to the Sherman Antitrust Act that are designed to regulate anticompetitive practices falling within the state's jurisdiction.

There are further similarities between state and federal regulation in statutes that impact the marketing and business practices of title assurance providers, as does RESPA. California, for example, has issued a regulation which is substantively similar to Section 8 of RESPA, and, as mentioned previously, has supplemented the regulation with specific prohibitions. We found similar prohibitions against rebates and discounts in Texas. Two of the states in our study, Texas and Washington state, attempt to address the problem of accuracy in determining the condition of title by requiring that a title insurer keep and maintain a title plant. Other states have made similar attempts to look to the quality of service by requiring agents to pass a written examination.

State authorities must also make a distinction between the business of insurance and the provision of settlement services. It is very important for the state regulators to make this distinction, since they must make sure that the insurance carrier is financially sound. Most states specify requirements for minimum capital, paid-in surplus, and loss reserves and regulate investments and reinsurance, all in order to ensure financial responsibility.

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[1] Goldfarb vs. Virginia State Bar Association, 421 U.S. 773 (1975).

Many state insurance commissions have not seriously examined this issue. Title insurance represents a comparatively small portion of the entire insurance industry, and it is assigned a low priority of attention. In 1967, a study of states that regulated title insurance rates revealed that 12 of 16 had never disapproved a rate proposed by the insurer.[1] Our own survey, together with interviews of key personnel in state insurance commissions, confirmed that many state commissions do not have the time or have not been able to allocate the resources to adequately understand the title insurance industry or to effectively evaluate title insurance rates.

In our survey of eight SMSAs, we observed considerable variation in the activities which are subjected to rate regulation. Most state insurance commissions exercise their authority to control rates by regulating the price schedule, which is formally labelled as being the insurance premium. Many states attempt to provide some greater degree of control over the final price actually charged for the package of title insurace-related services by defining title insurance to include some of those services. Colorado, for example, defines it to include the title search but excludes the settlement; Texas includes the search and settlement, but excludes preparation of documents. The current trend is toward regulating an "all-inclusive rate." A primary obstacle is whether the insurance commission has the authority to regulate fees for services which are considered to be legal services within that particular state. Normally, it does not,[2] but if the services are considered to be integral to providing title insurance, they are sometimes subject to the regulation of the insurance commission.

Another major variation in regulation that we found is in the determination of the rates to be used. Most states allow the individual title insurer to file the rate schedule which that provider will use, as is the case in California, Washington, Missouri, and the District of Columbia. Ostensibly, there may be some form of state approval associated with the filing, but pricing is effectively uncontrolled. There is a current trend away from this approach, however, and toward the establishment of uniform rates for the entire industry. These uniform rates are often set, as they are in Colorado, upon the recommendations of the industry, through an official or quasi-official rating bureau. In Texas they are set by the insurance commission after a formal, public hearing in which both industry experts and consumer advocates are given an opportunity to be heard and cross-examined.

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[1] The Title Insurance Industry and Governmental Regulation, 53 Va. L Rev. 1523, 1535 (1967).

[2] In Boston, therefore, where title insurance is not used, the rates for title assurance are not subject to any regulation.

One of the primary difficulties in the regulation of rates is that when a provider supplies the title insurance and also supplies another service for which the fee is unregulated, there is the potential that the final price for the entire package of services resulting in title insurance will be uncontrolled. As mentioned previously, the analyses of the prices and regulations actually encountered, and the need to regulate prices, are presented in greater detail in the other chapters of this report.

SUMMARY

The title assurance industry provides two basic functions that are very important to the real estate transaction. It makes a statement as to the exact condition of title, providing notice to the purchaser of the existence or non-existence of the rights of others; and it provides financial protection to back up its statement. The accuracy of the statement and the financial responsibility of the assurer are of critical importance to both lenders and home buyers.

The market for title assurance is characterized by reverse competition. Although one of the consumers of the service, the lender, is actively solicited for its business, the home buyer pays all the charges and premiums. Thus, the primary marketing mechanism for the sale of title assurance services is a system of referrals from other settlement providers who do not bear the financial cost of the service. The effect of this market condition on prices and other factors, the effect of regulatory attemtps to deal with this condition, and the various alternatives available to HUD to deal with this condition will be discussed in detail in subsequent chapters.

VI. LEGAL AND CONVEYANCING SERVICES

This section describes the legal and conveyancing services provided in the course of the typical real estate transaction and the role of the various providers of these services. Much of the information in this section will be based upon our surveys of settlement service providers in the eight sample sites as well as data from relevant trade associations and regulatory agencies.

The specific conveyancing services to be discussed in this section are the function of settlement or closing, escrow, and the preparation of documents, such as the mortgage and the deed. Though these procedures are fairly routine and simple, they are essential to the completion of the transaction. Historically, because these services involve the legal rights of all parties to the sales contract, they have often been performed by attorneys.

There is a trend, however, for other settlement service providers to perform these functions, particularly real estate brokers and title insurance companies. As a result, bar associations in many states have attempted to have the functions defined as legal procedures. Where the courts have agreed with the bar associations, the performance of the specified act by a non-attorney becomes an unauthorized practice of law, or UPOL, and is illegal.

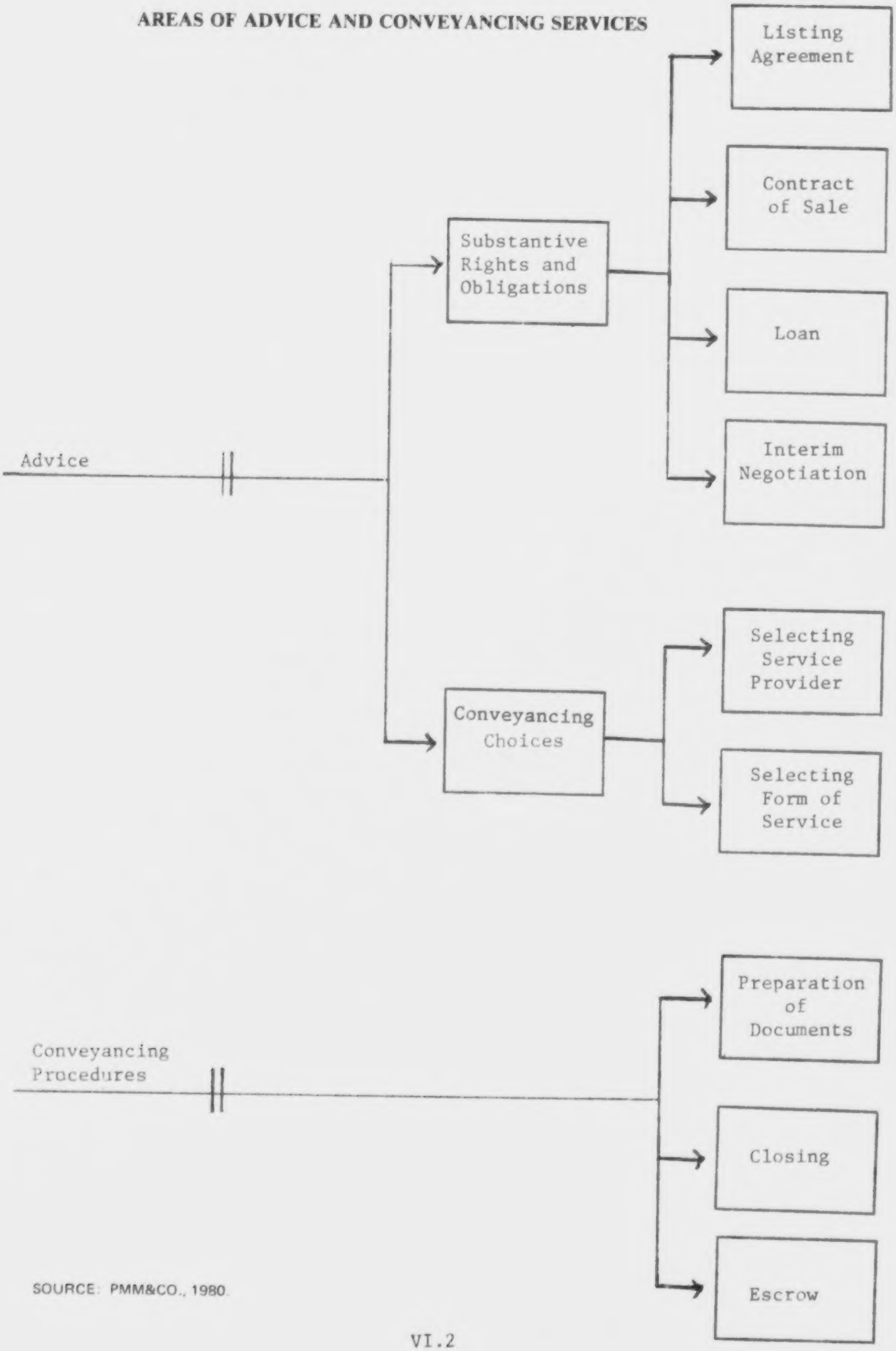
The role of the attorney in the real estate transaction process is not limited to advice and conveyancing procedures. A more important role is in the area of title assurance. In some geographic regions, attorney opinions of title validity are accepted by lenders and buyers. In other areas, attorney-agents for the title insurance companies are the primary providers of title work. This section provides information on non-title related functions, which are sometimes provided by title insurance companies as ancillary services. Some services are provided by several different provider groups depending on the customs of the area. Therefore, this section has been oriented toward functions rather than individual provider groups.

DESCRIPTION OF ADVICE AND CONVEYANCING SERVICES

In addition to title assurance, the attorney can perform two roles in the usual real estate transaction. One role involves giving the client, either the buyer or the seller, advice on each step of the real estate transaction. The second role involves the performing of certain conveyancing procedures, including closing or settlement, escrow, and the preparation of documents such as the deed and the mortgage note. The advice that an attorney can give a client covers several areas, as outlined in Exhibit VI-1.

EXHIBIT VI-1

AREAS OF ADVICE AND CONVEYANCING SERVICES


Listing Agreement
Contract of Sale
Substantive Rights and Obligations
Loan
Advice
Interim Negotiation
Selecting Service Provider
Conveyancing Choices
Selecting Form of Service
Preparation of Documents
Conveyancing Procedures
Closing
Escrow

SOURCE: PMM&CO., 1980.

Advice

Consumers have a need for advice in two areas: (1) negotiating terms and agreements, and (2) selecting local providers and services. In the area of negotiation, there are basically four times in the real estate process during which significant rights and obligations are established:

- the selection and preparation of the listing agreement;
- the written contract of sale;
- the negotiation of the loan terms; and
- the provision of all ancillary settlement services.

During selection and preparation of the listing agreement, the seller and broker are in an arm's-length relationship. Often the broker is negotiating with an uninformed consumer in a process that will determine the rights of the owner and broker with respect to such matters as the disposition of the earnest money if the buyer defaults, the rights of the broker if the seller's title is unmarketable, and the point at which the brokerage fee is earned. The vast majority of listing agreements are on standard forms drafted by, or on behalf of, real estate brokers. Often owners enter into agreements without the advice or assistance of an attorney who is knowledgeable in real estate and familiar with local practices and brokers.

The second major negotiation issue is the sale itself and the preparation of the written contract of sale. The contract of sale is perhaps the single most important legal document in determining the rights of the parties to the sale. This document is used to record the intentions of the buyer and the seller and to establish the precise terms of the agreement between them, including: (1) the selling price; (2) financing contingencies; (3) special conditions; and (4) items on the property which are to remain. As in the case of listing agreements, the vast majority of contracts of sale are on standard forms. Commonly, such forms are drafted by local bar associations, and the blanks are filled in by real estate brokers. Buyers and sellers frequently sign the final contract with the advice, in varying degrees, of one or more brokers but frequently not of an attorney. However, any unrepresented party may be at a severe disadvantage in assessing ostensibly "standard" terms and the legal effect of agreements made.

The third point of the real estate process establishing major rights is in finding a lender and agreeing upon the terms of the loan. The mortgage agreement establishes the long-term obligations of the buyer and the lender, including not only such major items as the interest rate, but also prepayment penalties, assumption rights, monthly escrow payments to the lender for property taxes, and the process to be followed in the case of default.

The final decision on major issues occurs between the contract of sale and the final closing. During this time, problems may arise that were not adequately addressed in the contract of sale. Difficulties can arise with the financing, survey, title search, repairs required by the lender, or problems with simultaneous sales. Each of these problems involves an intricate legal issue which is largely affected by real estate law and local custom.

The advice relating to the selection of providers and services generally has a lesser impact on long-term rights and values than does advice on other matters, but it has a large impact on the settlement process and costs. As demonstrated in the discussions of the various settlement service industries, the choice of a particular settlement service provider can be of significant importance to the consumer. Substantial differences may be noted in both the price and the quality of services. An incorrect title search, inaccurate legal advice, or an improperly drafted document can result in long-term problems, expenses, even loss of the property. It is important for both the buyer and seller to have the advice of someone who is familiar with the local providers, their current prices and policies, and their reputation for quality service. Often the broker performs this function for both parties. However, the broker represents the seller, not the buyer. Further, as the controlled business section of Title Assurance suggests the broker may have a vested interest in referring providers of title insurance, possibly in terms of his own remuneration and not the client needs. This may also be true in the case of attorney-agents who represent specific title insurance companies.

Conveyancing Procedures

A number of different requirements must be satisfied in a real estate transaction. Many procedures are specified by law and custom and are necessary to complete both the transfer of the property and the securing of the loan. Nevertheless, these procedures are often routine functions that are regularly performed on a volume basis, where applicable, by assistants and paralegals. Three basic functions have a significant role in the settlement process:

- the preparation of documents;
- the settlement or closing; and
- the handling of escrow.

The preparation of documents usually involves the preparation of a fairly standardized set of transfer and loan documents, usually a deed, note and mortgage or deed of trust. Occasionally, special clauses must be composed and added to the standard forms, but the procedures usually consist of filling in the appropriate blanks and accurately composing or transcribing a sometimes complex legal property description.

The closing or settlement function generally involves the final transfer and assignment of property as security for the loan. This includes the signing and exchange of documents; the completion of all other necessary documentation; the payment of such items as insurance, taxes, and recording fees; and the recording of the deed and loan papers in the appropriate public office. These procedures must be arranged and coordinated by someone who is familiar with all of the technical requirements and who can effectively respond to the vast array of problems that can arise at closing.

The escrow function is, basically, the process of receiving and disbursing funds. The escrow agent receives all of the funds in the transaction, usually in the form of certified or cashier's checks from the buyer and lender and disburses all of the funds as indicated on the escrow instructions, purchase agreement, or contract.

Though the legal and procedural services discussed above have been separated by functional distinctions, they are interrelated and can be provided by a number of different participants in the settlement process. In order to best describe the impact of legal and conveyancing services on the settlement service market, the different providers of these services and the roles they have in the entire process will now be discussed.

PROVIDERS

Because much of the advice and procedural assistance deals with legal rights, it has long been considered by attorneys to be the province of the legal profession. In addition to describing the role of attorneys in providing these services, this section will discuss the involvement of other settlement service providers, brokers, lenders and title companies, who also have a significant role in the provision of legal and conveyancing services.

Attorneys

The attorney's role in the conveyancing of residential real estate has evolved as a consequence of both custom and law. Both the general public and the practicing bar have developed perceptions as to the need for the services of an attorney in a real estate transaction, which differ by geographic area. As a result, the role of the attorney varies from one region to another.

In the early colonial period of the United States, attorneys were only infrequently involved in the transfer of real estate. The function of assisting and advising parties to a sale, "seems to have been performed by such non-lawyers as scriveners, notaries, or the parties themselves."[1]

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[1] L. Kinvin Wroth and Hiller B. Zobel (eds), The Legal Papers of John Adams, (Cambridge: Belknap Press of Harvard University), 1965, Introduction, pp. lx-lxi.

In the mid-Atlantic and southern colonies, patents to land were issued and passed from hand to hand, often with only a written assignment made on the back of the original patent. Early conveyancing was informal, and attorneys generally became involved only when patents were fraudulently assigned, went unrecorded, or produced overlapping claims, and so produced litigation.[1]

With the introduction in the early nineteenth century of the system for recording deeds and mortgages in a public office, the involvement of attorneys in the conveyancing process increased, primarily as providers of title searches and title opinions.

Eventually, attorneys increased their involvement in the conveyancing process, supplanting the justice of the peace and lay scrivener to become the primary real estate specialist.[2] The bar maintained this preeminence until the volume of transactions in urban settings made this system too cumbersome for attorneys to handle efficiently. Independent abstracting companies, later assisted by and affiliated with title insurance companies, developed to answer the more urban need for volume service.

In some markets, the title companies began to perform all of the traditional conveyancing functions. This trend has continued in many areas depending quite frequently upon the efforts of the bar to resist the change. Consequently, the legal profession tends to provide a variety of different functions in different areas. In areas such as New England, the attorney remains primary provider of all settlement services, while in others, such as the West, attorneys have only an incidental role in the conveyancing process. In the Southeast, attorneys also play a large role. The involvement of the attorney is often protected and perpetuated by local laws and rules defining the unauthorized practice of law.

In our survey of settlement service providers, we interviewed local attorneys, local bar associations, and state bar associations. Our discussions indicate that attorneys are generally available for each of the legal and conveyancing services described in this section, but that the services which attorneys actually perform on a regular basis vary widely from area to area.

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[1] As chains of title grew longer with successive transfer, the increasing complexity of land transactions helped still the anti-attorney sentiment prevalent in the early Republic. Conflicting or overlapping patents gave many attorneys substantial work in those years. See Maxwell Bloomfield, American Lawyers in a Changing Society, 1776-1876: American Lawyers and Social Change, 1776-1876 (Studies in Legal History) (Cambridge, Mass.: Harvard University Press) 1976.

[2] See Bellany Partridge, Country Lawyer, (New York: Charles Evans Hughes Press, publishing center for Cultural Resources, Inc.), 1939, pp. 7-10, 113-16.

Attorneys frequently do not get involved in a real estate transaction until after the negotiation for the listing agreement, contract of sale, and loan have already been completed, or substantially completed. Essentially they then perform one of the routine conveyancing procedures.

In our survey of local providers of real estate services, we asked which group of providers performed settlement services in each market site. Exhibit VI-2 indicates the answers provided by lenders. In most sites, at least two types of providers provide conveyancing services. In most individual transactions, the lender decides which procedure will be followed. Attorneys are used almost exclusively in Boston, and they are the primary conveyancing service providers in both the Washington, D.C. suburbs, and Jacksonville, Florida. In the remaining five sites, attorneys do not typically provide closing or escrow services, even though they may perform some procedural services. For example, San Antonio attorneys are required by law to prepare documents.

Exhibit VI-3 presents the national figures on the same question of which group provides settlement services. The question was asked of all providers: lenders, attorneys, title companies, and brokers. The answers vary depending on the provider. As this exhibit shows, attorneys and title company personnel believe their own groups provide these services a larger proportion of time than lenders do. We believe that lender responses are more accurate because a lender is involved with almost every transaction, whereas other providers are involved with only a small portion. However, these figures point out that even among professionals in the field of real estate, perceptions of who performs settlement varies. No data are available to specify which group actually provides convenyancing services in each area.

The consumer, in most parts of the country, the buyer, pays for the conveyancing services. Allegedly, when attorneys perform these functions, the costs to the consumer are higher than if brokers or title insurance companies provide the services. This issue will be addressed in Chapter XII. For purposes of that analysis, the extent of attorney involvement in each site will be assumed to be the lender responses presented in Exhibits VI-2 and VI-3.

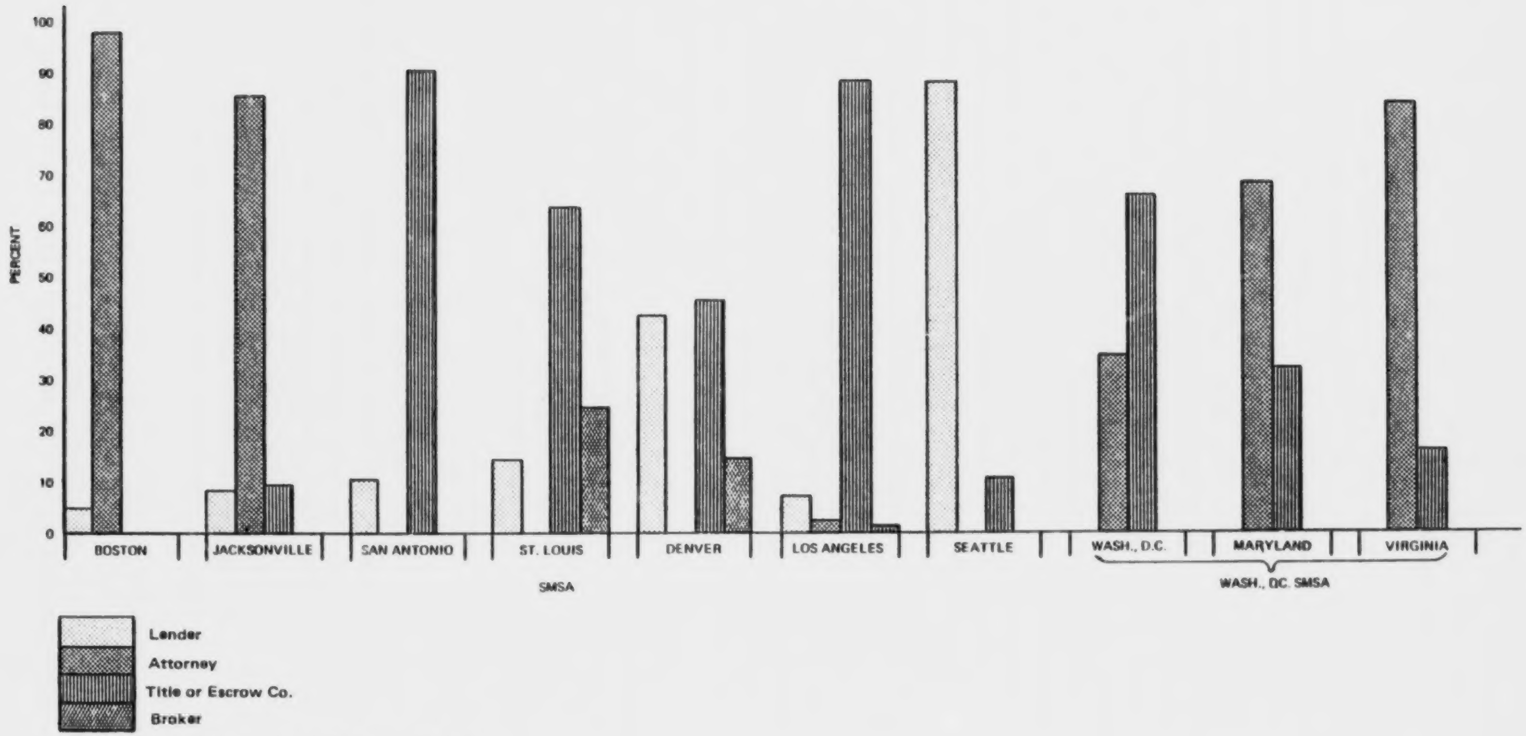
Title and Escrow Companies

As mentioned previously, there has been a trend toward increasing the involvement of title and escrow companies in providing the more routine conveyancing. Title and escrow companies have been the leading providers of conveyancing services in four of the eight sample sites: San Antonio, Los Angeles, St. Louis, and Denver. In two of the remaining four sites, the title and escrow companies are major providers of these services. Only in Boston and Jacksonville are title companies not a major provider of these services, though our interviews indicated that the use of title companies is increasing in Jacksonville.

It is quite evident, however, that title and escrow companies are generally limited to providing technical conveyancing assistance, i.e., settlement, escrow, and preparation of documents. The title company is

EXHIBIT VI-2

PROVIDERS OF SETTLEMENT SERVICES BY SITE



SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT VI-3

PERCEIVED CONVEYANCING SERVICE PROVIDER

PERCEIVED PROVIDER OF SETTLEMENT SERVICES
(Percentage of Services)

TYPE OF RESPONDENT	LENDER	ATTORNEY	TITLE OR ESCROW CO.	BROKER
Lender	21.5	31.5	42.5	4.5
Attorney	21.0	62.0	16.5	0.5
Title or Escrow Co.	18.5	18.0	53.5	10.0

1 Does not include responses for DENVER or L.A., where no attorneys were interviewed.

2 Does not include responses for BOSTON, where title companies do little business.

SOURCE: PMM&CO. Lender, Attorney, Title Company, and Broker Surveys, February 1980.

usually not involved in the transaction until after most of the decisions have been made. Furthermore, consumers with special legal problems prior to closing will not normally take them to the title company.

Brokers

In some areas, brokers provide legal and conveyancing services. Although they provide some conveyancing services in St. Louis and Denver, their more important role in all areas is providing direction and assistance through the settlement process.

The broker is in the strongest position of all real estate service providers to assist in choosing the lender as well as in negotiating substantive rights and obligations. The broker is typically the buyer and seller's first contact with any member of the real estate settlement service market. The consumer typically enters the settlement process inexperienced and uninformed about settlement services and providers. He specifically looks to the broker for guidance through a process which is totally unfamiliar.

The listing agent generally advises the seller in the negotiation of the listing agreement itself, as well as in the terms of the sale. Similarly, the listing agent provides advice during interim negotiations, unless an attorney is used.

The broker is in a particularly difficult situation when advising a buyer. As brokers are ostensibly the agents of the seller, they should be in an adversary relation with the buyer. Generally, however, the buyer has been shown a number of houses by brokers who are not the listing agents and who will not receive any compensation for services performed unless a property is purchased by this particular buyer. In such a case, the broker advises the buyer regarding the same areas in which the seller receives assistance. The buyer's agent also provides informal advice and referrals in the selection of other providers and services. The ethical considerations of this situation are not answered by the Realtors Code of Ethics, which merely provides that a realtor shall "treat fairly all parties to the transaction."[1]

This dilemma is even more difficult in the case of a listing agent in a sale where the buyer has not spoken with any other broker. In this case, both the seller and buyer specifically look to the same broker both for guidance through an unfamiliar process and advice in substantive matters such as price negotiation. There is a financial incentive, since the listing agent will receive a substantially larger commission only if this particular buyer purchases the property. The broker who tries to resolve this problem by representing both, and "treating fairly all parties," may be faced with a question or choice in which the advice to one will be influenced by a feeling of duty and a legal relationship to the other, or by the financial incentive for a completed sale. Quite frequently, none of the parties will be sufficiently knowledgable to be aware that a decision has been made which may have affected their rights.

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[1] Code of Ethics, National Association of Realtors, Article 7.

Lenders

Exhibit VI-3 shows that lenders sometimes perform closing and escrow services in seven of the eight survey sites. In Seattle, lenders have been the predominant provider of closing services. In Denver, they are a very close second to title insurance companies. Only in Washington, D.C., are lenders not involved in providing closing and escrow services. In Seattle, the state supreme court recently ruled that lenders could not perform settlement services for their own benefit as well as that of both buyers and sellers. However, the state legislature passed a law specifically allowing lenders to perform settlement services, as long as they made no specific charge for the activities.[1]

The role of the lender extends far beyond the completion of conveyancing requirements. In many cases, the lender specifies the requirements for settlement services, particularly title assurance, private mortgage insurance, and often attorney work.

In addition, the lender has one of the two critical advisory positions in the real estate process. As one of the providers with whom the buyer comes into contact early in the settlement process, the lender can provide advice in matters relating to the selection of other settlement service providers and in the choice of the type of services. The lenders often specify the form of title assurance and the use of an individual attorney for settlement.

Since the lender has knowledge of many of the settlement procedures, especially the completion of the mortgage papers, the institution is in a position to provide settlement services and document preparation for its own benefit as well as the mortgagor's.

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[1] See American Banker, "Start of New Law May End Washington State Bar, S&L Clash on Closing," August 29, 1979, p.1.

MARKET CHARACTERISTICS

Pricing Of Services

Advice on negotiation and service providers is generally informal and not charged to the recipient when it is provided by a non-attorney. However, if it is performed by an attorney in response to specific requests and problems of a client, the service takes the more traditional form of legal advice, and fees are charged. Traditionally, legal advice is supplied and charged on an hourly basis. Because of the informal nature of most forms of advice in discretionary matters, however, there is rarely a charge or fee which is specifically identified as being for such direction or assistance. Instead, most of the advice of this type is provided as a part of other major settlement services. A separate fee is usually charged for each conveyancing service. The pricing of such services varies widely among states and among types of providers. Many states have adopted an "all inclusive" rate for title insurance, which ostensibly includes many conveyancing services described in this section.

The primary difficulty in comparing prices and pricing structures between states is the problem of terminology. Identical services are referred to by a variety of names. On the HUD-1 form under Title Charges, there are spaces for:

- settlement or closing fee;
- abstract or title search;
- title examination;
- document preparation;
- attorney's fees; and
- title insurance.

One provider may include all of these services in one fee, which may be on the line for title insurance, while another may identify each item separately. In San Antonio, where the state has established an "all-inclusive" title insurance rate, supplemental fees are still charged for such items as escrow, preparation of documents, and attorneys' fees. Attorneys perform document preparation, and thus, their fees may be called either attorney fees or document preparation. As long as the rate for any one item is not established by state or local law, the pricing structure of legal and conveyancing services is subject to ambiguous terminology that prevents a meaningful comparison of prices for individual services. Only the total title charges in the 1100 series, including attorney's fees, gives accurate data for comparison. These comparisons will be presented in Chapter XII.

Referrals

The primary mechanism for marketing conveyancing services is referrals from other real estate professionals. This situation is essentially identical to the efforts for marketing title assurance. Frequently, they are the same efforts since the title assurance provider often performs the conveyancing services. Consequently, a more detailed discussion of "reverse competition" which characterizes the market for these services will be discussed in the section on title assurance.

Fees for the more routine conveyancing service procedures are generally less than those for title assurance. Further, except in the case of escrow companies, which exist on the West Coast, there are generally no completely separate industries for providing conveyancing services. Conveyancing is provided by suppliers of other services as an ancillary product.

REGULATION

Attorney practices are regulated for the most part through the state bar associations. Since minimum fee schedules were ruled violations of the Sherman Act,[1] prices charged for legal advice and conveyancing activities of attorneys are left up to the individual practitioner. There is no state-regulated rate for attorney fees. State regulation in the field of real estate transfer industries is for the most part reserved for the insurance industries, title insurance, private mortgage insurance, and state-chartered lending institutions.

However, the regulation of title insurance in some states affects attorneys who perform this type of service. For example, in Colorado the all-inclusive rate for title insurance set by the state insurance commission includes both title insurance and the search. That rate is fixed, whether the work is performed by a title company or by an attorney. Thus the attorney's fees for the search are regulated. However, the fees for document preparation, settlement, and escrow are not regulated. In Texas, the all-inclusive rate includes settlement but not document preparation. Furthermore, the law requires that document preparation be performed by attorneys only. Thus the charges for document preparation and attorney fees are unregulated in Texas even though ostensibly an all-inclusive rate for title work is charged.

Unauthorized Practice of Law

The other area of regulatory law that affects legal and conveyancing services is that of unauthorized practice of law (UPOL). These regulations define the activities that constitute the practice of law. Any non-attorney who engages in such activities is potentially subject to state prosecution for what is in many states a criminal offense. The determination of what act constitutes the unauthorized practice of law has historically been reserved to the judicial branch of the state government, and enforcement is typically carried out by the bar associations. However, even within a given state, actions that constitute a practice of law are not always clear.

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[1] Goldfarb v. Virginia State Bar, 421 U.S. 773 (1975).

Some states have enacted legislation specifically permitting non-lawyers to perform certain "legal" functions. Though most courts have tended to view these laws as "advisory," they almost invariably refuse to override them.[1]

Activities that are often covered by UPOL regulations include all of the legal and procedural services discussed in this section, as well as various components of title assurance activities. Most advice involving substantive rights and negotiation is considered to be legal advice. Such advice is almost universally prohibited if provided without the benefit of a license to practice law. A primary difficulty with this regulation is that most of the advice is provided on an informal basis and is not charged directly to the consumer. Such discussions are difficult to identify and prosecute. Most advice of this nature is proffered by real estate agents who advise buyers and sellers on contract terms and on ancillary conveyancing services.[2]

The greatest controversy in UPOL regulation is generated over the more formal, but more routine, conveyancing services: the preparation of documents, closing, and escrow. Within each of these categories, however, there is no clear universal definition of which acts may be performed only by attorneys.

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[1] "Unauthorized Practice of Law by Real Estate Brokers in New Jersey: A Call for Compromise," Rutgers Camden Law Journal, Vol. 2 (1970), at p. 334, cf. State ex rel. Reynolds v. Dinger, 14 Wis 2d 193, 109 N.W. 2d 685 (1961); Arkansas Bar Ass'n v. Block, 230 Ark. 430, 323 S.W. 2d 912 cert. denied, 361 U.S. 836 (1959); New Jersey Bar Ass'n v. Northern N.J. Mortgages Associates, 32 N.J. 430, 181 A. 2d 257 (1960), modified, 34 N.J. 301, 169 A. 2d 150 (1961); Hexter Title & Abstract Co. v. Grievance Comm., 142 Tex. 506, 179 S.W. 2d 846 (1944); State Bar v. Arizona Land Title & Trust Co., 90 Ariz. 76, 366 P. 2d 1 (1961), modified, 91 Ariz. 239, 371 P. 2d 1020 (1962).

[2] It is of interest to note a call for cooperation between lawyers and brokers published in a law journal: "The effects of a judicial decision prohibiting brokers from drafting some legal instruments can be chaotic. One need only look at the decision and aftermath of State Bar vs. Arizona Land Title & Trust Co. in which the state supreme court banned the preparation of all legal documents by realtors and title companies, except when acting for themselves as principals. The realtors, enraged at what they considered an unfounded attack by the legal profession, placed the question on the ballot and by an overwhelming four-to-one majority (passed a constitutional amendment which) removed from the judiciary the power over the practice of law." Id at 343.

Acting on a case-by-case basis, the courts have developed the following general tests to determine when a layman is engaged in the unauthorized practice of law:

- The incident-to-business test. A layman may perform whatever legal services are incidental and ancillary to established practices in his business.

- The simple/complex test. Simple legal tasks may be done by laymen; difficult and complex legal tasks must be done by an atttorney.

- The legal skill and knowledge test. A layman may act if no more than ordinary business intelligence is required; a layman may not act if the skill needed is peculiar to one trained and experienced in the law.

- The traditional practice test. The practice of law consists of those acts, whether performed in court or in the law office, which lawyers customarily have carried on from day day to day through the centuries.

- The personal representation or compensation test. A layman may perform legal services for himself or his employers, but is engaged in the authorized practice of law if he performs the same service for others.

- The public interest test. If it is beneficial to the public for laymen to perform certain acts, then this conduct is not the unauthorized practice of law; if it is harmful to the public, it is the unauthorized practice of law.

- The pretense of legal credential test. This is, in effect, a misrepresentation test. The essence of unauthorized practice is the attempt to deceive the public.

These divergent definitions of the practice of law have led to varying real estate transfer practices. No consensus of the states has been settled upon for any single identical rules. The only clear pattern seems to be to prohibit the readily identifiable cases of misrepresentation and cases of providing formal legal advice for compensation.

It is somewhat surprising that most disagreement about UPOL has centered on the particularly routine procedure of preparing documents. The simple instrument doctrine is a common rule which often is used to restrict non-attorneys from preparing the deed or loan papers and allows only the preparation of some other documents by filling-in a few identified blanks.[1]

UPOL in the Eight Relevant Sites

The relevance of the unauthorized practice of law issue to this study is the allegation often made by non-attorneys that attorney involvement keeps conveyancing costs higher than they would be otherwise. The theory is that UPOL laws required relatively expensive attorneys to perform simple tasks that could be performed more cheaply even at no cost by other persons involved in the process.

UPOL rules existed specifically in two of the eight sites used for this study. As was mentioned previously, Texas requires that attorneys prepare the deed and mortgage papers. The fees for this service are not included in the all-inclusive title insurance rate. In Virginia, attorneys are required to perform or supervise the title search and examination. In addition, a title insurance company cannot have an attorney in-house to perform this function. The attorney must be in private practice. This is the most stringent type of UPOL rule. In essence, title companies are barred from setting up plants and conducting their own searches.

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[1] These are usually restricted to "simple factual terms," such as: (1) date, (2) location of the property, (3) identification of the property, (4) price, (5) time or occupancy, (6) reference to promissory note, (7) date of tax allocation, (8) duration of offer, (9) date of acceptance of offer, and (10) reference to the receipt of the note as an earnest money deposit. Terms necessary to complete the financing clause and other requirements, however, are not within the scope of the phrase "simple factual terms." See Martin, "The Standard for Determining Unauthorized Practice of Law by Real Estate Brokers in Ohio," University of Cincinnati Law Review, Vol. 40 (1970) at p. 326 cf. Gustafson v. V.C. Taylor & Sons, 138 Ohio 392, 35 N.E. 2d 431 (1941). See also Chicago Bar Association v. Quinlan & Tyson, Inc., 23 Ill. 2d 116, 214 N.E. 2d 771 (1966).

In two other states, attorneys had lost the fight to have conveyancing functions declared a practice of law. Colorado courts refused to require that attorneys be used in cases decided over two decades ago.[1] As noted, in a more recent case in Washington State, the state bar association sought to have the courts deny the right of a savings and loan association to prepare documents and conduct closing for its mortgagors. Though the supreme court of the State of Washington agreed with the bar association, the state legislature subsequently passed a law specifically allowing lenders the right to prepare documents but not to charge a fee for the task. In addition, lenders could not insist on conducting closing if buyers had already hired an attorney for this job.[2]

Trends in UPOL Regulation

Our discussions and interviews with state and local bar associations confirmed the existence of a decrease in the protected status of the legal profession in the more routine procedural services. Many courts are deciding that the "legal" nature of such routine procedures as preparing documents is an artificial one. The courts have recognized that the state has the capability to adequately ensure that real estate professionals are qualified to perform these functions.

"The potential legal complications (in a real estate transaction) have moved some courts to insist that only the legal profession is capable of adequately servicing the public need.... It is clear, however, that courts are not justified in maintaining that the lawyer is the only person with the requisite morality, education, and intelligence to select or draft an instrument with legal significance."[3]

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[1] The court stated: "Though not controlling, we must make note of the fact that the record is devoid of any evidence of any instance in which the public or any member there of, layman or lawyer has suffered injury by reason of the act of any of the defendants sought to be enjoined . . . We feel . . . that the advantages . . . (of granting injunctive relief) are outweighed by the conveniences now enjoyed by the public . . . " Conway-Bogue Realty Investment Co. v. Denver Bar Association, 135 Colo. 398, 415-16, 312 P. 2d 998, 1007 (1957), quoted in "The Standard for Determining Unauthorized Practices of Law by Real Estate Brokers in Ohio," University of Cincinnati Law Review: Vol. 40 (1971) at 338. The controlling decisions in this field tend not to involve cases in which a broker is sued for inaccurate legal work. Rather, they tend to involve a seller reporting the allegedly illegal activity by a broker in order to avoid paying commission, or a bar association seeking an injunction to prohibit the "legal" activity.

[2] See American Banker, "Start of New Law May End Washington State Bar, S&L Clash on Closing," August 29, 1979.

[3] Rutgers-Camden Law Journal, Ibid. at 339.

SUMMARY

The providers of legal and procedural services provide two major forms of advice that are very important to consumers in the settlement process. In a system with which the typical consumer is completely unfamiliar, they: (1) provide essential advice in matters that affect substantive rights and negotiations, and (2) provide essential assistance and direction through the process, referrals to particular providers of other services, and suggestions relating to the form of settlement service. Providers who participate in and provide this segment of legal and procedural service are in a very powerful position to affect the demand in other settlement service markets.

The provision of the generally more routine procedural services, on the other hand, is a sometimes separate market which itself is characterized by reverse competition. The prices for these services frequently represent a significant percentage of the total price for all settlement services. The role of legal and procedural services in the pricing of the settlement process and the effect of regulatory efforts to deal with those prices will be important in evaluating the performance of the entire settlement service market.

PART 2: PERFORMANCE OF THE SETTLEMENT SYSTEM

Part 2 presents the major finding of this study regarding the markets for the various settlement services. Chapter VII presents the criteria by which the settlement service markets will be evaluated. These are:

- Does workable competition exist?
- Is the consumer well served in the individual markets?

Chapter VIII presents a general overview of the common economic characteristics of the various settlement service industries. While each industry has its own particular structure for the pricing and provision of services, there are certain economic features common to many of the industries. The most common characteristic is reverse competition.

Chapters IX through XII present the individual industry studies in the same order as the background chapters appeared in Part 1:

- Brokerage Process;
- Mortgage Lending Process;
- Private Mortgage Insurance Industry; and
- Title Assurance and Conveyancing Services.

Title Assurance and Conveyancing services has been combined in Part 2. The markets for these services overlap to such an extent that analyzing them individually was impossible. The providers of title assurance in a given transaction usually provide the necessary conveyancing services.

Each industry is analyzed using the basic criteria of Chapter VII. The following market and product characteristics were evaluated to determine whether workable competition exists:

- homogeneity of product;
- number of market participants;
- barriers to market entry; and
- well-informed consumers.

While there are other characteristics of pure competition, these appear to be the most relevant for the purpose of this study. In addition, extensive analysis of pricing data was conducted in most cases. Data developed from the HUD-1's, the consumer and provider surveys, and our interviews with state and national regulatory agency, trade associations, and market participants will be presented in each chapter to help determine whether workable competition exists and, in the end, whether consumers are being well served in each market with respect to price, quality, and delivery of services.

VII. FRAMEWORK FOR EVALUATING PERFORMANCE OF SETTLEMENT SERVICE MARKETS

RESPA was designed to affect the provision and use of settlement services, especially their prices and the markets in which they are bought and sold. These aspects of settlement services are determined in markets where those services are bought and sold. The participants in each market are the consumers, that is home buyers and sellers, and the settlement service providers. Although much of the analysis of the effectiveness and effects of RESPA and the assessment of the need for further regulation requires varying specific methodologies, all require information concerning the performance of settlement service markets. Therefore, in addition to evaluating RESPA and proposed alternative interventions, we also need to evaluate the performance of the major markets for settlement services. These services are:

- brokerage;
- title insurance;
- private mortgage insurance;
- legal services; and
- lending.

The analysis of each of these markets is designed to:

- assess the performance of each settlement services market in terms of providing required services at the lowest possible cost;[1]
- assist in the evaluation of the impact of RESPA on settlement service market performance;
- provide information that should be useful in evaluating policy alternatives to RESPA; and
- provide information that should assist in evaluating the potential effects of specific policy alternatives.

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[1] By "required" we mean those services that are required for settlement or are demanded by a well-informed consumer

OPTIMAL PERFORMANCE CRITERIA

In an optimal situation, the following conditions would prevail regarding the provision of settlement services:

- settlement services would be provided to the consumer at the lowest possible cost;
- provided services would reflect consumer needs, regarding both quantity and nature of services.

In the jargon of the economist, these conditions describe economic efficiency in the markets for settlement services. The lowest possible cost criterion relates to both technical efficiency in the production of those services and the markup over cost (profit) that is included in the price to the consumer. In the long run, the optimal level of profit should be just enough to induce firms to supply the demanded level of settlement services.

The second criterion is more complex, largely because of the imprecise notions of what a well-informed consumer would need or want to purchase. Related to this is the complexity of the settlement process and fact that most consumers are infrequent purchasers of settlement services. This is further complicated by the characteristics of particular settlement services being determined or influenced by government agencies, semi-governmental bodies or lenders rather than by the consumers who pay for the services.

Pure Competition And Economic Efficiency

Pure competition can be shown to result in economic efficiency, that is required products and services being produced most economically and being provided to the consumer at the lowest possible price. In a market characterized by pure competition, suppliers are forced to provide services at a low cost as there are always other providers ready, willing and able to do so. In the real world, pure competition rarely exists and for several reasons could not be expected in the settlement service markets. It is important to study its characteristics, however, as movement in the direction of a more competitive market will tend to result in greater economic efficiency and lower cost for the consumer.

Outside of the economics literature, the term "competition" is often used to denote rivalry. That is, firms are quite conscious of the fact that their behavior -- pricing, product design, advertising, etc. -- affects the actions of their competitors which in turn affects their own behavior. This situation is very common where a few firms provide most or a significant portion of the products or services in a particular market. This market structure is very different from pure competition and tends not to result in a high degree of economic efficiency. We would generally expect costs to the consumer to be higher where economic rivalry exists than would occur where the market structure is characterized by or approximates pure competition.

Characteristics of Pure Competition

A purely competitive market for settlement services satisfies the following conditions:

1. Providers offer a homogeneous service and consumers are identical from the providers' point of view in that there are no advantages or disadvantages associated with selling services to a particular consumer.

2. Both providers and consumers are numerous, each provider and consumer acts independently and the sales or purchases of each individual unit are small in relation to the total aggregate volume of transactions so that the actions of one provider or consumer do not affect the actions of other providers or consumers.

3. Both providers and consumers possess perfect information about prices available, and they take advantage of every opportunity to increase profits and satisfaction respectively.

4. No substantial barriers exist to entry into and exit from the market for providers and consumers.

Condition 1 ensures the anonymity of providers and consumers. Consumers have no reason to prefer the services of one provider to those of another. The uniformity of consumers ensures that a provider will sell to the highest bidder.

Condition 2 ensures that many providers face many consumers. If providers are numerous, an individual provider can increase or reduce his service level without noticeably altering the market price for such services. An individual consumer's demand for the service may rise or fall without any perceptible influence on that market price. The individual buyer and seller are too small to have any influence on price and merely adjust to what they consider a given market situation.

Condition 3 guarantees perfect information on both sides of the market. Consumers and providers possess complete information with respect to the quality and nature of the service and the prevailing price. Since there are no uninformed buyers, providers do not attempt to charge more than the prevailing price. Consumers cannot buy from some provider at less than the prevailing price for analogous reasons. Since the product is homogeneous and everyone possesses perfect information, a single price must prevail in a purely competitive market. (However profits may vary.)

Note that pure competition is beneficial because it provides for an efficient market. Furthermore, pure competiton is an absolute. We can speak of a market being more nearly competitive than another. This may be referred to as "more competitive." However, since there are four conditions for pure competition, the only unambiguous comparison of degree of competition is if one market more nearly satisfies at least one of the conditions than does another market and satisfies the other conditions no less.[1] In practice, these criteria are very difficult to apply except in extreme circumstances, where the relative extent to which markets satisfy the conditions are obvious.

Applying these criteria to one market is much easier. Consequently a policy which increases the degree to which a market satisfies one of the conditions can be said to move the market toward pure competition, unless there is reason to believe that it also reduces the extent to which one or more of the other conditions is satisfied. For example, if RESPA results in consumers being better informed regarding settlement service prices and characteristics and does not affect the extent to which the other conditions for pure competition are met, RESPA can be said to have increased competition for settlement services. The fact that a particular policy change results in increased competition is not adequate, however, to determine if that policy change is desirable but it does provide a framework for developing potential policy alternatives.

For policy making purposes, it is desirable to be able to determine if a market is performing satisfactorily, even if the criteria for pure competition are not met and economic efficiency is not achieved in the strict sense. Where the criteria for pure competition are met to a significant extent and active price competition exists, this might be characterized as "Workable Competition." This would generally occur where both consumers and providers are reasonably well informed about prices and product characteristics, and there are numerous buyers and sellers in the market. While product characteristics may differ somewhat among providers, a high degree of consumer price sensitivity exists for comparable products. Where workable competition does exist and the consumer appears to be reasonably well served in terms of cost, quality and appropriateness of settlement services, the burden is obviously greater for justifying regulation or other intervention into the market than where competition is less robust.

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[1] There is an economic theory which casts doubt on the desirability of moving towards pure competition. The theory of second best suggests that if one or more of the conditions for efficiency cannot be satisfied because of institutional constraints, in general, it may not be necessary nor desirable to satisfy the remaining conditions. However, there is general agreement among economists that efficiency could be expected to increase as substantial progress is made in satisfying the criteria for pure competition. This indeed is the rationale for current efforts to deregulate and develop active competition in the airline, trucking, and communications industries.

CRITERIA FOR EVALUATING MARKET PERFORMANCE

Our next task is to develop explicit evaluation criteria for determining the performance of the settlement service markets. While a determination of the degree of competition is important in this regard, it is not the end in itself. A broader, more comprehensive evaluation strategy is required which focuses on market performance in terms of cost of services, but also on quality and appropriateness of service.

There are three primary criteria to be used to evaluate how well the settlement service markets are performing in providing consumers with required settlement services at the lowest possible prices. They are, the extent to which:

- the four primary conditions for pure competition are met;
- the principal manifestations of whether "workable" competition exists; and
- certain non-price related indications of acceptable market performance exist.

As discussed earlier, the four conditions which define pure competition are:

- homogeneous product or service;
- numerous independently acting buyers and sellers;
- perfect information about price and product characteristics; and
- no substantial barriers to entry or exit from market.

If not all are met--a rare occurrence in our economy--economic efficiency is attained. As noted above, however, economic efficiency may exist to a significant extent where active price competition--workable competition prevails. The criteria for determining the existence of workable competition are, of necessity, imprecise. Although there are numerous factors which taken together can help determine whether workable competition exists, the pricing behavior of a product is among the most important. Evidence of the persistence of unusually high profits, excess capacity, low productivity or relatively high marketing costs typically identifies the absense of workable competition. Where settlement services prices are regulated, such as by state insurance commissions, the persistence of these conditions would indicate that prices are excessive and the consumer is being ill served.

Some indicators of market performance are not readily determinable from a solely economic picture of the market. These are included in the third of the broad criteria listed above:

- institutional factors which determine product characteristics;
- legal requirements for specific services that may not be required;
- tied relationships among settlement providers;
- provider abuses sanctioned by custom or regulation;
- other characteristics of the product, marketing mechanisms, or provider community which may result in a higher cost or inappropriate settlement service.

To some extent the three primary evaluation criteria are redundant in that information as to whether the four conditions for pure competition are or are not met provides some indication of the market performance for that settlement service. However, if the four conditions are not fully met as they likely will not be for any settlement service, the level of performance in terms of price and adequacy of product is ambiguous. An evaluation of more explicit manifestations of market performance such as long term trends in pricing, industry profitability and excess capacity is required. In addition, there are some measures of market performance related to adequacy and appropriateness of the product and some "consumer" issues such as those related to provider abuses which are not amenable pure economic evaluation.

Listed below are specific settlement market evaluation criteria which will be used to evaluate settlement service market performance. For some settlement services, not all are applicable, nor will relevant information be available for all of the criteria. Considered together, however, these should provide a good assessment of the extent that the consumer is being well served by receiving required settlement services at a cost close to the lowest possible cost of providing those services. This evaluation is useful in determining whether additional reforms or regulations are desirable and the kind of intervention that is likely to result in improved market performance.

Explicit Evaluation Criteria

A. Criteria relating to four requirements of pure competition

   1. homogeneous product

      a. degree of product uniformity
      b. extent of variation in quality of services

2. numerous independently acting consumers and providers

   a. market share data
   b. number of active providers
   c. evidence of mechanisms which preclude independence of sellers in determination of price

      - existence of trade organizations which set or influence price

      - regulatory authority which sets or influences price

      - commonly adhered to price schedules

      - existence of mechanisms to provide price stability

      - collusion

3. well informed consumers and providers

   a. extent of consumer information

      - prices

      - need for specific settlement services

      - characteristics of settlement services (and differences among providers)

   b. impediments to acquiring information

4. barriers to entry or exit from market

   a. regulatory barriers to entry

      - excessive financial requirements
      - excessive training requirements
      - outright barriers to new entrants

   b. institutional barriers
   c. requirements to join specific organizations

      - high membership fees
      - other barriers to membership

   d. high capital requirements

B. Criteria to determine the existence of workable competition - active price competition

1. extent of price variablity
    a. over time
    b. at a specific point in time
    c. over changing market conditions

2. extent of reverse competition
    a. marketing to other providers rather than to consumers
    b. extent of payments for referrals - high commissions favors, free service, etc.

3. reasonableness of profits - evidence of monopoly profits
    a. extent of persistence of high profits over time
    b. pattern of firms with early market position of having persistent high profits

4. productivity - efficiency of production
    a. high marketing expenses over time
    b. persistence of excess capacity in industry
    c. long term prevalence in market of inefficient procedures

C. Other criteria for acceptable market performance

1. Extent of tied relationships
    a. nature of relationships - controlled business, overlapping boards, etc.
    b. extent of referral patterns and utilization patterns among boards, etc.
    c. price differences between tied providers and independent providers

3. existence of provider abuses
    a. misleading description of services or of need for services
    b. non-return of refunds, excess payments, etc.
    c. poor quality of services
    d. inappropriateness of services
    e. reduction in scope of service unbeknown to consumers (i.e., exclusions from title insurance policies).

This list is not intended as complete nor are each of the factors relevant for an evaluation of all settlement service markets. Most provide some hint as to how well the market is performing, although one would have to look at several factors taken together to draw meaningful conclusions.

An example of this is evidence concerning active price competition. The existence of a single price for most transactions, where the price (or commission rate) is constant over a period of changing market conditions and there is some mechanism which could help maintain these rates (multiple listing service, insurance commission rate schedule) would suggest the absence of active price competition. On the other hand relatively uniform prices where prices change frequently (mortgage interest rates), where there are numerous sellers, and where there is no obvious mechanism which can support price uniformity would suggest relatively active price competition. In the latter case, inefficient high cost providers could not compete successfully over the long run and would not likely survive.

The presence of substantial variability at a point in time in the price of a uniform service is generally indicative of a non-price competitive market. It would typically suggest considerable consumer ignorance about prices or the inaccessibility of certain suppliers to consumers.[1] Also, the persistance of excessively high profits among providers generally suggests the absence of competitive market pressures which could moderate excessive prices and profits. The absence of high profits, however, is no indication of a well-functioning market. This may be particularly relevant where reverse competition exists. In that situation, relatively high prices may be maintained but, instead of profits being high, providers may engage in costly marketing activity to compete for referrals. Firms could actively compete for referrals through high commission rates, gifts, kickbacks or by providing services to the referrer which are unrelated to the settlement service provided to and paid for by the consumer. The cost to the consumer where reverse competition exists is likely to be higher than where providers compete directly for the consumer's business through active price competition.

The existence of active price competition is preferred to a lack of active price competition but may not result in the efficient provision of services. There may be institutional constraints (i.e., inefficient title recording system, legal constraints, etc.) which prevent the production of required services in the most efficient way. In fact, some services may not be required at all were it not for certain institutional practices and legal requirements.

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[1] Substantial price variability at a point in time could also indicate temporary market disequilibrium. If price variability persists, it would suggest lack of active price competition.

This is why the evaluation of market performance must include an evaluation of the institutional and legal and regulatory constraints, which constitute part of the third evaluation category, the non-price indications.

CONCLUSION

These considerations should assist us in assessing the performance of the settlement service markets, and in assessing the impact of RESPA on market performance. By providing some indication as to the level of market performance and what particular market characteristics appear to be related to poor market performance (to the extent it exists), this evaluation is an important input into whether policy interventions are warranted and which interventions may be beneficial.

VIII. RELEVANT ECONOMIC FACTORS IN THE MARKET FOR SETTLEMENT SERVICES

In many respects, the market for real estate settlement services is unique. The motivation behind the purchase of settlement services, the complexities relating to some of the services, the infrequency of purchase, the economic characteristics of the provider industries, and the often substantial legal and regulatory constraints all combine to differentiate settlement services from the markets for other consumer goods and services. The results have been substantial market imperfections and prices which, in many cases, are above what would be expected if the markets were characterized or approximated by perfect competition. This chapter presents an overview of the economic motivations and characteristics of both consumers and providers in the markets for settlement services. A more detailed analysis of the economic performance of the individual settlement service markets is provided in Chapters IX through XII.

The demand by consumers for settlement services may be defined as a derived demand. The need for settlement services occurs only when a house is purchased and thus is considered derived from the demand for houses. Since settlement services may be purchased only a few times in a lifetime, most home buyers do not obtain the often considerable technical and cost information needed to become well-informed consumers.

While settlement services may be defined as a derived demand, they can also be considered a "transaction cost". These costs are incurred only when ownership of a piece of property changes. Transactions costs occur in many markets but are of special significance in the capital markets where funds are lent or used to purchase equity. Substantial transaction costs occur when a firm wishes to borrow funds and floats a debt issue in the bond market. A considerable portion of the transactions costs involved with the transfer of real estate arises for the same reason as they do in other capital transactions: lenders desire information and assurances related to the safety of their invested funds.

A large portion of real estate settlement costs arises as a result of mortgage lenders attempting to minimize their own risk. Title insurance protects the lender against future claims by persons asserting a legal interest or claim against or to the property. Mortgage insurance protects the lender against loss by default of mortgagors who have a large loan-to-value mortgage. The lender's attorney assures that the documents and transfers meet the legal requirements of the area, and he may also do the title search. These providers of settlement services are ultimately dependent upon the risk-averse nature of lenders. The borrower, however, pays the providers directly even though he may not choose to purchase those services.

This situation does not differ significantly from that in most other capital markets. Borrowers assume the responsibility for proving their own credit-worthiness. A relatively unique aspect of the residential real estate settlement markets is that most borrowers may not be well-informed about prices, product characteristics, and differences among providers. Settlement services are not purchased frequently and their cost is low relative to the cost of the house. There are a number of separate services that are purchased from different providers. Many of these services are complicated and the implications and nuances sometimes obscure.[1] In addition, laws, regulations, and lender practices often determine how settlement services are defined and, in many cases, from whom they will be purchased and the price that will be paid. This is particularly true for title insurance and mortgage insurance. In some states, insurance commissions regulate most aspects of these lines of insurance including prices. In other states regulation is less restrictive.

The result of the complexity of the situation and the constraints on choice has led to consumer dependence on others to arrange for settlement services. Exhibit VIII-1 shows some common referral patterns for settlement services. The initial referrers are most typically real estate agents and lenders. Where real estate agents are not involved in the sale, other referral patterns may evolve. For instance, a lawyer may be the initial contact of the seller and/or buyer and may be an important referral source. In other localities, lawyers are only minimally involved in real estate closings and would not typically be either a source or recipient of referrals. Nevertheless, the pattern of infrequent direct contact, without previous referral, with providers of settlement services (at the bottom row of Exhibit VIII-1) persists in most areas.

The intent of the proponents of RESPA was to increase consumer knowledge, encourage consumers to shop for settlement services themselves, reduce the need for referrals from real estate brokers and lenders, and ultimately, reduce the cost of settlement services. This goal cannot be met if consumers still do not find it desirable or cost-effective to become knowledgeable regarding settlement service requirements and prices.

CONSUMER INFORMATION AND SHOPPING

For the individual home buyer, the array and complexity of settlement services necessary to buy a house can be overwhelming. Even if a home buyer has previously bought a house, the procedure may differ each time. Since the need for settlement services occurs only when a house is purchased, many consumers never spend the time necessary to become knowledgeable about both the technical and cost aspects of settlement services.

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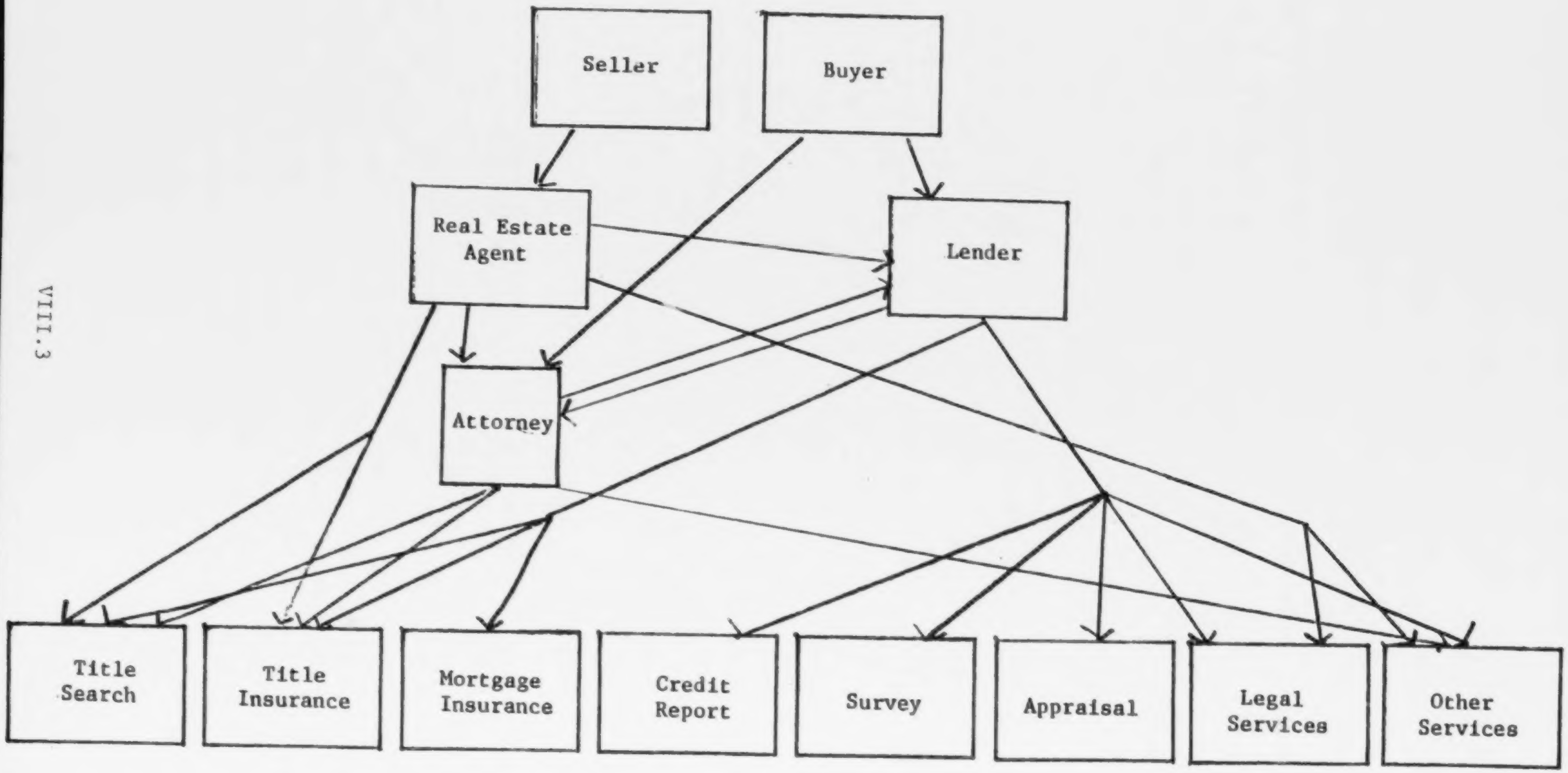
[1] This is particularly true in the case of title insurance where often two policies covering different contingencies are purchased.

EXHIBIT VIII-1

Common Patterns Of Referrals For Settlement Services


Seller
Buyer
Real Estate Agent
Lender
Attorney
Title Search
Title Insurance
Mortgage Insurance
Credit Report
Survey
Appraisal
Legal Services
Other Services

SOURCE: PMM&CO., 1980

Factors which discourage active consumer shopping for settlement services are:

- the time (and cost) required to become well informed;
- the complexity of settlement services;
- the consumer's perception of uniformity of prices and product characteristics; and
- the discouragement of shopping by some elements of the system.

These factors are discussed in some detail.

There are a number of services that a home buyer is required to purchase. These services are, in addition to any points and origination fees paid to the lender, property taxes, transfer taxes and escrow amounts. The primary home buyer services of interest to this study are title insurance, private mortgage insurance, and legal services. In addition, the home buyer will probably be required to pay for an appraisal of the property, a survey and a credit check. Finally, homeowner's insurance must be paid in advance for one year. The seller will generally be responsible for the real estate broker's fees and termite inspection. These services are typically purchased from different providers. Thus, any consumer who shopped for every item could have many hours of work, even to locate two or three providers of each kind of service. Due to the infrequent need for most of these services and their low cost relative to the cost of the house, many home buyers do not expend the time, effort and cost of actively shopping for these services.

In addition to the large number of services the average home buyer must purchase, he would need to understand the items to be able to shop effectively. In addition, some items appear complex without some study. This is particularly true of title insurance. Rarely does the average consumer know what contingent situations are covered by either the lender's or owner's title insurance policy. Mortgage insurance may also seem obscure to most purchasers. Thus, the complexity both of number of services and types of services may overwhelm potential home buyers and discourage shopping.

Another deterrent to shopping for settlement services is the apparent uniformity of prices. Many consumers believe that shopping will not be useful because most prices are identical. In the case of private mortgage insurance and title insurance, prices are often regulated by state insurance commissions. Some states set fixed prices. For example in Colorado and Texas, an all-inclusive rate for all title assurance services is set by the state. Consumers would have no incentive to shop for cheaper rates in these states. Other states use a less formal file & use form of price regulation. Title insurance companies often charge separately for several different products, such as insurance, title search, document preparation, closing and others, but frequently the only prices filed for review are the insurance rates. While the insurance rates may be uniform in many states, total title related charges typically vary from one firm to another. Nevertheless, consumers may not be aware of these differences.

In the case of private mortgage insurance, rates vary only slightly from one company to another. Real estate brokerage, however, may provide the most important example of uniform pricing. Residential real estate commissions charged by most conventional real estate brokers are either 6 percent or 7 percent, depending on the locality. These commission rates, while not fixed as part of any regulatory mechanism, have remained remarkably stable through changing market conditions and periods of rapid inflation in housing prices. This phenomenon is discussed in greater detail in Chapter IX.

A corollary to the uniform pricing characteristic of settlement services is that most settlement services are not differentiated from one provider to another, at least from the perspective of the consumer. Consumers view title insurance as a uniform product, whomever the insurer. This is true for mortgage insurance and some other settlement services as well. If both products and prices are viewed as uniform, consumers would have little incentive to spend time trying to shop for better prices or higher quality services.

Finally, consumers are discouraged from shopping for settlement services in cases where legal, regulatory and lender practices serve to prohibit or discourage the exercise of choice among providers. This subject will be discussed in subsequent chapters, but at this point it should be mentioned that insurance commissions, to a varying extent, regulate the provision and prices of both title insurance and private mortgage insurance. In addition, lender regulatory agencies and secondary loan markets often define the loan security that is required. Lenders are allowed to choose both the mortgage insurer and the attorney, if one is used, even though the cost is paid directly by the consumer. Thus, in many cases, a consumer is denied his choice of providers even if he understands the entire settlement process and desires to actively shop for providers.

All of these barriers to consumer understanding and choice have caused reliance on other providers to make arrangements for settlement services.

REFERRAL SYSTEM

Settlement service providers such as title insurers, private mortgage insurers, surveyors, appraisers, and, in some cases, attorneys are not usually contacted first by home buyers or home sellers. Rather, the consumer is typically referred to particular providers by the initial contact providers (real estate agent, lender, attorney) and often never comes into direct contact with these providers. This is both a cause and effect of low consumer awareness of settlement practices.

Referrers

Real estate agents are the first providers that many home buyers contact. The process of looking for a home may take some time and often a home buyer uses a particular agent to help him find the house that fits his needs best. When he locates a house, the agent is obviously in a position to help the buyer complete the home buying process. He may help the home buyer find a lender, an attorney, a title insurance agent, an escrow company, or other service providers. In some localities, the real estate agent is central to the settlement process. He may arrange the contract of sale, the provision of other services, and even the closing.

In other areas, the lender is the focal point in arranging for services. The lender may be recommended by the real estate agent initially, but he then arranges for the other service providers. In almost all cases, the lender chooses the mortgage insurer, if one is used, and the appraiser. However, in cases where the lender is central to the process, he may also recommend the attorney or title work provider. Federally chartered savings and loan associations, for example, are explicitly allowed to have their own attorney review documents at the mortgagor's expense if any other attorney or title company is used to provide the title work and document preparation. Usually the closing itself is also conducted by the document preparer whether this is an attorney or a title insurance company.[1]

Industries Dependent Upon Referrals

Aside from appraisers, surveyors, and credit check agencies, the suppliers which most often receive referrals are mortgage insurance companies and title assurance providers. Lenders are allowed to require the use of a specific mortgage insurance company if a home buyer has a high loan-to-value ratio mortgage. Because it is the lender's interests that are being protected, the financial institution regulators have allowed the individual banks and associations to make the decision concerning the insurance company. However, the buyer pays the insurance premium.

Title assurance providers may be either title companies or attorneys. The title companies can be direct branches of the underwriter or independent title companies. Attorneys often act as agents for a title insurance company. Usually the attorney arranges for a title search and evaluates the information. The insurance company then issues an insurance policy based on the attorney's evaluation. Depending on the locale, the pattern of referrals differs. Either lenders or real estate brokers are the primary referrers in any given area.

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[1] Except in California where escrow companies are used.

Attorneys are in the unique position of both receiving referrals and giving them. They are often referred to home buyers by real estate agents and lenders and in turn are in a position to refer business to title insurers and other settlement providers.

Reverse Competition

The situation where providers compete primarily for sources of referral of business rather than for business directly from the consumer (who pays for the product) is called reverse competition. As noted above, most title assurance, mortgage insurance and other settlement service business comes through referrals from real estate agents, lenders and in some areas, attorneys. As a result, competition for these referred services takes the form primarily of reverse competition. This can have important cost implications for the consumer. There is often little incentive to compete by offering services at lower prices, as the referrer may not be very concerned if the consumer is offered services at the lowest possible prices. This price insensitivity discourages the use of price reduction to increase sales and may encourage price increases. Reverse competition involves wooing the referrer, often through expensive marketing campaigns, some form of explicit or implicit referral fee or by performing favors or services for the referrer which may be unrelated to and of no direct interest to the consumer. This would tend to cause the cost of settlement services where reverse competition is involved to be higher than where active price competition, or what we have termed workable price competition, prevails.

If referrers are receiving kickbacks, rebates, gifts or other payments, then they are receiving excess profits in relation to their work product. It was these practices which Congress sought to eliminate with section 8 of RESPA, which says in part:

> SEC.8 (a) No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.
>
> (b) No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed.

The additional cost to the consumer of settlement services may be reflected in the persistence of unusually high profits, high marketing expenses or the cost of carrying excess capacity. Where firms are not forced by competitive market forces to provide services at their input cost,[1] unusually high profits may persist. Alternatively, the marketing effort to gain referrals may be costly. It is possible, however, that these marketing costs are less than would occur if these settlement services were marketed directly to the consumer. Another potential ramification of high settlement service prices, resulting from reverse competition, high regulated prices or other factors, is excess capacity in the industry. Where substantial barriers to entry do not exist, new firms will enter the industry or existing firms will expand in response to perceived high settlement prices. Rather than decreasing prices as a result of the increased supply, each firm may provide fewer services. This excess capacity would be reflected in lower industry productivity than if active price competition prevails.

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[1] Including a market rate of return, or profit.

High marketing expenses, where it exists, will reflect marketing activity aimed at referrers rather than consumers. It may sometimes be reflected by explicit payment for referrals, which, in a sense, is a split of the excess profits in the industry with the referrers.

Information on situations prior to RESPA had shown cases of attorneys paying builders and developers for the right to do the title work on a large piece of land. The builder would then require all the home buyers in the development to use the attorney to perform their title work. The new policies required only an update from the original builders policy, but full fees for title searches and evaluation were charged.[1]

Another form of inflated costs may be high commissions paid to those that write title insurance policies by the title insurance companies. Agencies, attorney agents, and others typically receive a percentage of the insurance or indemnity premium as a commission. This commission, even when it is 50 percent or more of the premium, is technically not a violation of section 8 of RESPA.

The impact of RESPA on referral fees is treated in Chapter VI. It may be noted here that there appears to have been a reduction in the incidence of explicit and illegal referrals fees - kickbacks, large gifts and other forms of obvious payment for the referral - but perhaps an increase in the use of legal mechanisms which have the same purpose and impact on cost to the consumer - high commission rates and tied relationships among providers (discussed below).

Another approach used in competing for referrals is to provide free services to the referring provider. In the case of mortgage insurance, some companies offer help in marketing mortgages in the secondary markets and other technical assistance. This assistance, while helpful to the lender in many cases, may provide no benefit to the home buyer who is paying for it. Moreover, because it is offered free to the lender, he will use the services as long as it provides him with some positive benefit, even if this benefit is substantially below the cost of providing the service. It would be more efficient if the lender would pay for the services he needs.

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[1] See Ronald Kessler, series of articles entitled "The Settlement Squeeze" in The Washington Post, January 9-12, 1972. Following these articles, Congress began an investigation of settlement practices. One result of these investigations was RESPA.

Another characteristic of reverse competition is the strong incentive to internalize referral fees. This can be done by real estate brokers and lenders establishing an ownership interest in other settlement providers. Referral is then automatic to the controlled provider and dollars that may have appeared as referral fees or high commissions are now internalized as additional profits to the company providing both services.

Competition for sources of referral, whether manifested through referral fees, high commissions, free services to the referrer or other means, is likely to result in higher settlement costs to the consumer. While competing directly for the home buyer and seller's business may include extensive advertising campaigns, because many of the services are uniform from the perspective of the consumer, price is likely to be a primary factor in deciding among competing providers. Thus, we would expect lower settlement prices where providers compete directly for well-informed home buyers and sellers. At this point, however, for reasons indicated earlier in this chapter, many home buyers and sellers cannot be considered to be well-informed regarding important aspects of settlement services, prices, and providers.

It is important also to note that the high prices for settlement services do not stem primarily from some of the more well known, classical (in economic theory) causes of high prices. Monopoly, (one supplier), oligopoly (only a few suppliers) or substantial barriers to entering into the market tend not to be characteristic of settlement service markets and therefore are not primary causes of high prices. Consequently, some of the classical remedies such as increasing the number of suppliers and removing barriers to entry will not significantly improve the performance of settlement service markets.

SUMMARY

Economic factors that to some extent determine the structure of the market for most settlement services are lack of adequate consumer information, reverse competition, regulated prices and other factors which tend to preclude or discourage active price competition. These factors have contributed to the provider relationships and situations that exist today. Referrals have always been an integral part of the system. While each of these economic conditions is not unique to the settlement service industries, their combined effect has been to reduce competition among settlement providers and to increase the cost of settlement to the consumer.

An understanding of the basic economic characteristics of the conveyancing industry is crucial to an analysis of the performance of settlement markets. The markets for the provision of each major settlement service will be analyzed in-depth in the next chapter. The discussion here and in Chapter VII is intended to provide an analytical framework for the analysis.

IX. PERFORMANCE OF THE BROKERAGE PROCESS

RESPA was designed to influence the provision of settlement services related to the transfer of single family homes[1] in terms of the type, quantity, and price of services provided. While some may contend that the real estate brokerage industry does not participate in the settlement process and is therefore outside the scope of RESPA, an evaluation of the performance of settlement markets would be incomplete without an assessment of this industry's participation in the transaction process.

This assessment is important to the broader examination of RESPA for two reasons. First, industry participants[2] (i.e., the brokerage firm and its brokers and agents) are frequently the first contact point for buyers and sellers of single family homes. The firm may play a pivotal role in the decision of the consumer to buy (or sell). The firm may also have the opportunity to assist in the selection of other settlement service providers.

Second, the real estate brokerage commission paid to the brokerage firm is often the largest component of charges paid by the seller at settlement. Since one of the objectives of RESPA is to minimize settlement cost to the consumer, it is logical to examine this component as well as the other settlement-related charges as part of an evaluation of the RESPA legislation.

CHARACTERISTICS OF THE BROKERAGE INDUSTRY

Chapter II of the report describes the brokerage industry on the basis of limited data. Those characteristics contained in Chapter II that are important to the analysis of the market for real estate brokerage services are reviewed in this section. These features include the principal providers of brokerage services, the services offered, product pricing, and the regulatory environment faced by the industry.

Principal Providers

The industry is principally composed of many small firms that compete in a local marketplace. Perhaps the most important distinguishing characteristic among all firms is the level of services offered and the corresponding pricing structures employed. Three types of firms have been observed:

- the traditional firm, which offers a complete set of listing and selling services and prices these services on a percentage rate basis;

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[1] Single family homes are both new and existing homes. In our study, we focus only on the sale of existing single family homes.

[2] In this report, we will use the terms "brokerage firm", "broker", and "agent" interchangeably. We will distinguish between them when such a distinction is germaine to the study.

- the discount firm, which offers a reduced set of listing and selling services and prices these services on a percentage rate basis but at a lower rate than the traditional firm; and
- the flat fee firm, which primarily offers listing services and prices these services on a flat dollar basis.

While types of firms may vary significantly in regard to services and the pricing strategies, they do share a common purpose: to match buyers and sellers of homes for the purpose of concluding a sale and subsequent settlement.

A second distinguishing characteristic among types of firms is the method by which personnel are engaged. Typically, traditional and discount firms engage their agents as independent contractors. The agents engaged by these firms are compensated through commissions that are based on performance. In contrast, the flat fee firm typically employs its personnel and pays them direct salaries.

Related to this characteristic is the relationship of brokers and agents. A real estate broker is a licensed individual who can independently offer his or her services for a fee. In contrast, a real estate agent is an individual who can offer his or her services for a fee only if he or she is under the direct sponsorship of a real estate broker. Thus, a broker can own and operate a brokerage firm, whereas an agent cannot.

These features may have important implications for industry productivity because the dependent, contractor status of the agent makes it easy for the firm to hire new personnel when the firm attempts to expand its market coverage. This is relevant because a primary means of expanding coverage is to increase the number of salespeople working in each geographical area. If an increase in salespeople occurs without an increase in the supply of houses for sale, more salespeople are competing for the finite supply, resulting in a decline in productivity.

Nature Of The Product

All brokerage firms match buyers and sellers of homes to conclude a sale and assist in the resolution of post-contractual requirements. There are, however, some differences in services offered by different firm types. Typically, the discount and flat fee firms offer fewer services than the traditional firm. Whereas listing services appear to be common to all firms, discount and flat fee firms offer only limited showing services.

The traditional firm offers to perform those services necessary to sell the home of a consumer who lists the home with that firm. A specific list of services is not offered. If the first prospective buyer who is shown the house by the listing firm agrees to purchase the listed house, then the firm has fulfilled its responsibility to the seller. Generally, however, most firms advertise listed properties, place them on the multiple listing service (MLS), hold open houses, and chauffeur many prospective purchasers to see their listed properties before a sale is completed.

Related to the nature of services provided by the traditional firm is the basis on which compensation is earned. Typically, the commission earned by the firm is a contingent fee; that is, the property must be sold before the firm obtains its fee. A firm may make prodigious efforts to sell a listed house, but if it fails and its listing agreement expires, the firm receives no compensation for its work. Thus, the firm is at risk and must depend upon its ability to conclude a sale within the time identified in its listing agreement.

Nature and Extent of Regulation

Historically, the real estate brokerage industry has not been highly regulated. However, recent trends in antitrust law and consumerism indicate that the industry's regulatory environment is changing and may become more restrictive than it has been in the past.

Like other businesses, the brokerage firm and its personnel are subject to common law. Because the firm bases most of its performance on contractual agreements between itself and its clients, common law provides the structure which governs the basic operations of the industry and its participants.

Historically, state law has been the primary regulatory influence over the industry. Of particular importance are the state licensing laws. While state requirements may vary, every member of the industry must comply with statutory procedures in order to obtain and maintain a valid license. Regardless of interstate differences, each set of laws addresses three primary elements:

- parties subject to the provisions of the act;
- activities specifically required and prohibited; and
- sanctions provided, including both remedies and enforcement procedures.

These laws also specify requirements for licensing such as completing real estate courses and passing a licensing exam.

The statutes also establish a state regulatory commission, which is charged with the responsibility of formulating more specific regulations, managing the licensing procedures, and enforcing the provisions of the law and rules of the commission. Our limited observations indicate that such commissions are staffed by only a few persons and may not have the capacity to effectively monitor the practices of the industry and also manage the administrative procedures (e.g., licensing) within its domain. Further, the commission's enforcement activities generally are a function of consumer complaints. To the extent that consumers do not register a complaint, enforcement activities may be limited.

While state law has been the primary regulatory vehicle influencing industry actitivy, a recent U.S. Supreme Court ruling may have significant impacts on industry regulation and behavior. In the case of McLain vs. Real Estate Board of New Orleans[1], the Supreme Court decided that the defenses to federal antitrust jurisdiction traditionally employed by local broker organizations in the past are not legally sufficient to exempt them from antitrust regulation. The practical meaning of this decision is that the full range of federal antitrust law is now a very active component of the industry's regulatory environment.

Analytical Constraints

Chapter II discussed the difficulties experienced during our data collection efforts. Because of the lack of adequate information from industry sources we must rely more heavily on data from the seller and buyer interviews, other published sources, and our limited field experience.

INDUSTRY PERFORMANCE UNDER THE CRITERIA FOR PURE COMPETITION

Under pure competition, a condition of economic efficiency is achieved. That is, the consumer is provided with a product at the lowest possible cost. While pure competition rarely exists, it is important to study its characteristics because industry movement in the direction of a more competitive market will tend to produce greater economic efficiency.

A purely competitive market for settlement services must satisfy the following conditions:

- providers offer a homogeneous service in that there are no advantages or disadvantages associated with buying from a particular provider or with selling services to a particular consumer;
- both providers and consumers are numerous, each provider and consumer acts independently, and the sales or purchases of each individual unit are small in relation to the total aggregate

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[1] 100 S. Ct. 502 (1980).

volume of transactions, so that the actions of one provider or consumer do not affect the actions of other providers or consumers;

- both providers and consumers possess perfect information about prices available, and they take advantage of every opportunity to increase profits and consumer satisfaction, respectively; and

- no substantial barriers impede entry into and exit from the market for providers and consumers.

In the subsequent analysis, we will examine the real estate brokerage industry in terms of these criteria. While these conditions are not fully satisfied by most industries (including the brokerage industry), they do provide an analytical framework and will be useful in our discussion of workable competition.

Criteria 1: Homogeneous Product

The provision of a homogeneous product by industry members facilitates comparison shopping by the consumer. If services are similar, then the consumer can make a decision based on the prices offered by each firm. For the most part, the brokerage industry offers a relatively homogeneous product. While there is product differentiation across firm types (Traditional, Flat Fee, Discount), firms within the same grouping essentially offer similar products. The range of services offered across firm types does allow the consumer to choose the level of service desired. However, our survey of sellers indicates that nearly all (94.1 percent) choose a full service standard commission brokerage firm to provide the desired listing and selling services.

Traditional Firms

According to the sellers interviewed in our study, there is little difference in the services offered by traditional firms. Sellers indicated that a large majority of the firms they engaged provided the set of services one would expect. The percentage of firms providing each service is listed below.

Type of Service	Percentage of Firms that Provided This Service
Advertise the listing	85.3%
Place in MLS	87.4%
Screen buyers	70.7%
Show home	89.5%

Type of Service	Percentage of Firms that Provided This Service
Hold open house	61.3%
Negotiate contract	79.5%
Complete post-contract work	72.3%

Only one service, holding open house, was provided by fewer than 70 percent of the firms, according to the sellers interviewed. However, 89.5 percent of the firms showed the homes on a more informal basis. The open house format, therefore, may not be an essential component of a firm's sales effort.

The list of services a firm provides may vary by the type of listing agreement signed by the seller. In our sample, the distribution of listing agreements was as follows:

- exclusive right to sell: 44.9 percent;
- exclusive agency: 10.7 percent; and,
- open listing: 42.9 percent.

One would expect the firm to make a greater sales effort on the more restrictive listing agreements. When a firm knows that it will receive a commission, (because of an exclusive right to sell listing) it is more likely to expend a greater effort.

Last, the firm's use of the MLS as a marketing device does not appear to be a distinguishing service characteristic. In fact, 87.4 percent of the firms provided this service.

Given that services do not differ significantly among traditional firms, consumers must use other criteria when selecting a firm. Among the 83 percent of sellers who used a broker, it appears that firm reputation was the most important criterion for their choice of broker. When asked why they selected a particular firm, most sellers (68.2 percent) said they were given a reference, and 16.2 percent said they had used the firm in a prior transaction. Thus, more than 80 percent chose a firm because of its reputation.

Alternative Firms

As stated earlier, alternative firms offer a reduced service package compared to their counterparts in the industry. Their importance as an alternative for the consumer appears minimal. Whereas 76.1 percent of the sellers were aware of alternative firms when making their selections, less than 6 percent actually engaged one.

Variation in Service Quality

Because of the limited data available from the industry itself, we cannot make a judgment about variations in service quality. However, considerable evidence suggests that consumers generally are satisfied by the firms they chose, which may suggest little variation among firms. In response to three separate questions, we found that:

- most sellers (64.7 percent) would use the same agent again;
- most sellers (82.9 percent) used full service standard commission firms on their previous homes; and
- most sellers (81.4 percent) were at least somewhat satisfied with their agent.

While these data can be used only as a proxy to measure variation in service quality, the strong positive attitudes of the sampled sellers suggests that good service is relatively standard.

Criteria 2: Numerous Independent Sellers and Buyers

The existence of numerous sellers and buyers of services reduces the influence of an individual's action on the market price for the services being purchased. As described previously, the industry comprises many small firms. Approximately 63 percent of the firms have only one office. Typically, small firms consist of no more than five or six people. Neither national nor local market share data are available, but one of the largest national firms, Coldwell Banker, reports only a 5 percent national market share.

While numerous firms exist in most large urban areas, several factors may influence the independence of these firms. These include the industry's history of pricing, the local board's importance, and the reinforcing nature of the MLS and cooperation.

Industry History of Pricing

As discussed in Chapter II, in the past the brokerage industry promoted uniform pricing. Although the U.S. Department of Justice obtained a consent order in 1971 prohibiting even recommended rate schedules, a recent case in Montgomery County, Maryland, indicates that the industry has maintained an interest in the uniform pricing concept.

In this case, six firms (including the presidents of three of the firms) were indicted and later convicted of entering into an agreement in September 1974 to raise residential commissions from 6 to 7 percent. While this case concerned only six firms and not the entire industry, it does suggest the perpetuation of the notion of uniform pricing as an industry institution. Moreover, efforts to retain the existing commission rate would generally not require explicit collusion, nor would they likely result in indictments. For part of the industry's history, setting industry wide commission rates was a legitimate pricing strategy. Although intentional uniform pricing is no longer legal, industry customs are often slow to change and may limit an individual seller's independence.

Local Board of Realtors

The term "realtor" is a trademark of the National Association of Realtors (NAR) and its members. At the local level, NAR-affiliated local boards provide a framework for the local real estate profession. Membership dues generally are not prohibitive, and membership appears to be open. Of the 12 alternative firms interviewed, five stated that they belong to the local Board of Realtors.

The MLS and Cooperation

Two practices often supported by local Boards of Realtors may influence individual behavior. These are the Multiple Listing Services and the practice of cooperation. These two mechanisms are, perhaps, the two most important factors influencing price stability. The practice of cooperation is a general agreement among board members to equally share the commission earned when two firms are involved as the listing and selling agents in a transaction. Because the MLS generally publishes the available commission rate, all member firms are aware of the rate, and it thus can serve as a self-policing mechanism. The agreement to share commissions may discourage firms reducing their commission rate below the prevailing level.

The MLS is also generally sponsored by a local board; this MLS membership is predicated on board membership.[1] Of the 12 alternative firms interviewed, seven said they did not belong to an MLS. Because the MLS provides an inventory of homes to sell, nonmembership is an important disadvantage.

Further, MLS participation implies and reinforces cooperation. Alternative firms charge less for their services and, therefore, have less to share with traditional firms. A discount firm can overcome this difference if it provides the standard share to the cooperating firm. However, a flat fee firm that charges a lower dollar fee may not have a standard share to offer.

Because they charge reduced fees, alternative firms often cannot offer to cooperate on their listings.[2] In turn, traditional firms have little incentive to cooperate with such firms when cooperation is not mutual or when it is based on a reduced fee. Of the 16 alternative firms that responded to a question about cooperation, six claimed that they had been refused cooperation. Because cooperation is based on a mutual agreement to share available commissions on an equal basis, it is not surprising to observe that some firms will not cooperate with firms that do not offer a comparable commission.

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[1] As noted in Chapter II, the NAR estimates that approximately 60 percent of MLSs are operated by local boards.

[2] Some firms do offer to cooperate by offering 3 percent to the selling broker and 1-2 percent for themselves.

Criteria 3: Information Balance

If buyers and sellers possess perfect information, then a single price should prevail in a purely competitive market. If consumers are knowledgeable, then providers will not try to charge more than the prevailing price. If providers are knowledgeable, then consumers should not be able to buy services at a price below the prevailing price.

While most consumers appear to be informed about general market processes, there is some question as to the depth of their knowledge. Consumers do not appear to thoroughly investigate the market or the different brokerage firms available to sell their homes. Most sellers (78 percent) considered only one or two firms before selecting a firm to list their house. Less than 10 percent of the sellers considered more than three firms. Less than 10 percent of the sellers considered more than three firms. While one might expect a seller to conduct an informal survey of homes for sale in their neighborhood before establishing a listing price, 60 percent of the sellers did not view any house before setting a price.

There is indication, however, that consumers are aware of the different firm types that are available to them. As noted earlier, 76.1 percent of the sellers were aware of the existence of flat fee or discount firms.

Criteria 4: Barriers to Entry and Exit

Barriers to entry and exit in real estate brokerage are minor for traditional firm members. Potential barriers include licensing requirements and membership in local boards and the MLS. Whereas the licensing procedure presents little difficulty for the applicant, membership in a local board or MLS may be difficult for some alternative firms. Nonmembership in an MLS may be most significant as it limits the firm's access to homes and reduces the services it can offer to potential customers.

In response to questions about obstacles faced in the conduct of their business, alternative firms claimed many impediments. Of the 11 firms that responded to a question on general impediments, eight alternative firms stated that they had been impeded by obstacles. Six firms state they were refused cooperation. Five firms stated that newspapers refused to carry their ads. Seven firms said they had experienced harassment from other brokers.

Summary on Pure Competition

The four criteria discussed above provide a framework for examining the performance of the real estate brokerage industry. Satisfaction of these criteria would indicate that an industry performs in a purely competitive manner. We do not expect any of the industries under study to satisfy all of the criteria. However, satisfaction of some criteria might indicate that an industry acts, to a certain degree, in a competitive manner.

The real estate brokerage industry does possess some of the characteristics necessary to satisfy some of the criteria. Service providers are numerous, offer similar services, have generally the same information, and enter or exit freely. However, these characteristics hold true only when analyzing firms are characterized as traditional firms. Information, for example, is not as easily available to alternative firms who cannot obtain membership in MLS. Some barriers also may be more significant for alternative firms than they are for traditional firms. Further, while firms and their members are numerous and therefore should not be able to influence market prices, other mechanisms appear to be operating to limit the independence of sellers of brokerage services. We, therefore, must look at workable competition as a second analytical framework on which to evaluate the industry's performance.

WORKABLE COMPETITION

As described in Chapter III, the criteria for workable competition cannot be defined precisely, but they include some degree of satisfying the four criteria for pure competition, along with evidence of competitive pricing among providers and other indications that services are provided efficiently and at reasonable cost. This section examines four important issues:

- active price competition;
- extent of reverse competition;
- reasonableness of profits; and
- industry productivity.

Where workable competition exists, corrective market forces will tend to pressure firms into providing services at a cost at, or close to, the miminum cost of production.

Active Price Competition

It is important to indicate the degree of price variation that is consistent with workable or active price competition. If the market for brokerage services is in equilibrium and the product is homogeneous, then a single market price for brokerage services at a point in time suggests either of two conditions: near perfect competition or near perfect collusion. A final judgment must be based on the presence of other indications of market competitiveness. On the other hand, wide variation in prices for a homogeneous product would tend to suggest very limited consumer information and a poorly functioning market, as well informed consumers would be foolish to pay more than the lowest price available.

If a single market price existed across localities or over time periods and fluctuating market conditions, this would tend to indicate that active price competition was not present. Rather, it would suggest that mechanisms exist which tend to prevent the market price from adjusting to different market conditions.

The extent of price variability for a homogeneous product that would seem most indicative of active price competition is a relatively narrow price range in a given market at any point in time. Over time and across market areas, we would expect variation in prices to reflect changes in market conditions. Thus where active price competition is present, we would not expect the maintenance of a single dominant market rate during periods of both slack and unusually heavy real estate activity.

To examine the extent of active price competition in the industry, we have obtained commission rate data from a sample of 1979 HUD 1 settlement forms in eight markets. These data are supplemented with data from Michael Carney a consultant who analyzed the HUD-1 data from 1975 and 1978. In each case, we employ calculated commission rates (actual commissions paid dovided by actual sales prices) for existing home sales.

PMM&Co. data for 1979 indicate that in all but one market site (Jacksonville, Florida) there is substantial clustering of commission rates paid at 6 or 7 percent. Exhibit IX-1 illustrates the distribution of commission rates. In St. Louis, the District of Columbia, San Antonio, and Los Angeles, the percentage of commissions paid at exactly 6 percent are 85.6 percent, 84.0 percent, 81.8 percent, and 80.0 percent respectively. In Denver and Seattle, 59.0 percent and 57.4 percent of the commissions paid were at 6 or 7 percent respectively. In contrast, a much wider distribution was observed in Jacksonville, Florida. Because of lack of cooperation by providers, we were unable to collect data concerning local market conditions and we cannot attribute this wider distribution to specific factors.

The Carney data indicate similar clusterings at 6 and 7 percent for 1975 and 1978. These data are presented in Exhibit IX-2. Several additional cities were included in this study. In 1975, two-thirds or more of the commissions were either exactly 6 or 7 percent in five of the seven cities for which we have data. In 1978, this was the case in five of eight cities.

The same data can be used to measure pricing patterns over time in the four cities common to both the Carney and PMM&Co. studies. In Exhibit IX-3, the distribution of commissions paid in each of the four common cities (Boston, Los Angeles, the District of Columbia, and Denver) are compared for 1975, 1978, and 1979.[1]

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[1] In Boston and Denver, data are available only for 1975 and 1979.

EXHIBIT IX-1

DISTRIBUTION OF CALCULATED COMMISSION RATES FOR 1979

	N	(%)	LESS THAN 5%	AT 5%	5%-6%	AT 6%	6%-7%	AT 7%	GREATER THAN 7%
. Boston	94	7.9	6.4	3.2	6.4	53.2	2.1	22.3	6.4
. Denver	100	8.4	6.0	8.0	3.0	23.0	1.0	59.0	0
. Washington	75	6.3	1.3	5.3	4.0	84.0	1.3	4.0	0
. Jacksonville	267	22.5	6.7	3.0	1.9	18.7	19.5	30.0	20.2
. Los Angeles	30	2.5	3.3	3.3	6.7	80.0	0	6.7	0
. St. Louis	202	17.0	7.4	3.0	1.0	85.6	1.5	1.0	0.5
. San Antonio	55	4.6	10.9	7.3	0	81.8	0	0	0
. Seattle	366	30.8	3.0	7.4	2.5	27.9	1.4	57.4	0.5
TOTAL	1189	100.0	5.6	5.1	2.5	44.6	5.4	31.7	5.3

SOURCE: PMM&CO. HUD-1 Survey, 1979

EXHIBIT IX-2

DISTRIBUTION OF CALCULATED COMMISSION RATES FOR 1975 AND 1978

	N	(%)	LESS THAN 5%	AT 5%	5%-6%	AT 6%	6%-7%	AT 7%	GREATER THAN 7%
	1975								
Bridgeport	206	22.1	7.3	4.4	3.9	83.0	1.0	0.5	0
Boston	34	3.6	26.5	0	8.8	55.9	–	2.9	5.9
Washington	66	7.1	4.5	7.6	1.5	68.2	3.0	12.5	1.3
Orlando	35	3.7	5.7	11.4	0	17.1	0	51.4	14.3
Des Moines	113	12.1	0	0.9	0	13.3	2.7	79.6	3.5
Denver	102	10.9	6.9	0	2.9	4.9	2.0	83.3	0
Los Angeles	378	40.5	9.0	4.2	2.6	77.8	0.8	5.6	0
Total	934	100.0	7.5	3.7	2.7	59.4	1.3	24.1	1.3
	1978								
Washington	65	15.3	4.6	3.1	0	72.3	0	20.0	0
Los Angeles	23	5.4	8.7	4.3	0	78.3	4.3	4.3	0
Houston	50	11.8	10.0	10.0	0	80.0	0	–	0
Columbus	84	19.8	3.6	3.6	1.2	56.0	1.2	33.3	1.2
Atlanta	13	3.1	7.7	0	7.7	–	7.7	69.2	7.7
Rochester	82	19.3	6.1	1.2	4.9	51.2	3.7	29.3	3.7
Portland	41	9.6	14.6	4.9	0	17.1	2.4	56.1	4.9
Seattle	67	15.8	3.0	11.9	0	7.5	7.5	68.7	1.5
Total	425	100.0	6.4	5.2	1.4	48.5	2.8	33.9	1.9

SOURCE: HUD-1 and Other Data, Survey, 1979.

EXHIBIT IX-3

DISTRIBUTION OF CALCULATED COMMISSION RATES FOR FOUR CITIES IN 1975, 1978, AND 1979.

CITY	YEAR	N	LESS THAN 5%	AT 5%	5%-6%	AT 6%	6%-7%	AT 7%	GREATER THAN 7%
BOSTON									
	1975	34	26.5	0	8.8	55.9	0	2.9	5.9
	1978	NA	NA	NA	NA	NA	NA	NA	NA
	1979	94	6.4	3.2	6.4	53.2	2.1	22.3	6.4
LOS ANGELES									
	1975	378	9.0	4.2	2.6	77.8	0.8	5.6	0
	1978	23	8.7	4.3	0	78.3	4.3	4.3	0
	1979	30	3.3	3.3	6.7	80.0	0	6.7	0
WASHINGTON, D.C.									
	1975	66	4.5	7.6	1.5	68.2	3.0	12.5	1.3
	1978	65	4.6	3.1	0	72.3	0	20.0	0
	1979	75	1.3	5.3	4.0	84.0	1.3	4.0	0
DENVER									
	1975	102	6.9	0	2.9	4.9	2.0	83.3	0
	1978	NA	NA	NA	NA	NA	NA	NA	NA
	1979	100	6.0	8.0	3.0	23.0	1.0	59.0	0

SOURCE: M. Carney, Memo to T. Papageorge, FTC, May 1980 and PMM&CO. HUD-1 Survey, 1979.

Each of these years reflects substantially different market conditions for the real estate brokerage industry. While local market conditions do not follow the national pattern precisely, they are typically affected by some of the same factors, such as recession, inflation and money shortages. Often patterns within individual markets are more extreme than the national market patterns, but the extent of variation over time at the national level is suggestive of the nature and, perhaps, the extent of variation being experienced in many of the larger urban areas.

In 1975, sales activity was moderate, despite the selection. The number of existing single family home sales increased 7.9 percent[1] (to 2,272,000) from the previous year, which had been a poor one. Dollar volume of home sales, after correcting for inflation, increased 8.0 percent.

On the other hand, 1978 was a highly increased year for the industry. The number of existing single family home sales was 3,905,000, up 9.3 percent from 1977 (also a good year) and up 59.3 percent from 1975. The dollar volume of home sales, in constant dollars, rose 17.2 percent from 1977.

In contrast, 1979 was a poor year for the industry. Unit sales declined by 4.2 percent. The contrast dollar value of existing single family home sales actually declined slightly, reflecting only the second such decline in more than a decade. In summary, 1975 was a fair to good year for the real estate brokerage industry, 1978 was a boom year, and 1979 was a poor one, declining both in volume and sales revenue.

An analysis of these data suggests that prices have remained relatively constant at the 6 or 7 percent levels during the 1975-1979 period. In Los Angeles and Washington, D.C., commissions paid seem to have become more uniform over time. In Boston, there were fewer commissions at less than 5 percent in 1979 than there were in 1975, perhaps reflecting a decline in number of discount brokers and a larger number of commissions at 7 percent. In Denver, there was a decline in the proportion of commissions at 7 percent and a corresponding increase in the proportion of 6 percent. This pattern was also observed in Washington, D.C.

Last, we examined the distribution of commissions paid over three different ranges of sales prices: $35,000 to $40,000; $55,000 to $60,000; and, $75,000 to $80,000. Similar clusterings of commissions paid were observed in the eight market sites for 1979, as illustrated in Appendix H. While the available sample of transactions at each rate and within each price range is very small, the continued pattern of clustering we observed does suggest that prices appear to be relatively uniform.

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[1] Data for number of units sold and dollar sales volume supplied by the NAR.

PMM&Co.'s seller survey provides some indication of the extent to which sellers negotiate with brokerage firms and the extent to which they are successful. These findings are summarized in Exhibit IX-4 of the 202 sellers surveyed, 21 were successful in negotiating a reduced commission.

The data on price variation indicate a considerable amount of price uniformity. This pattern of commission rate uniformity was observed:

- within localities;
- at a given point in time;
- across localities; and
- over the 1975-1979 period.

In most sites there was some variation from the predominant 6 and 7 percent commission rate, but no clear indication of whether this price variation had increased or decreased over time. During the 1975-1979 period, the HUD-1 data indicate that the average price of a home increased 45 percent, compared to a 24 percent increase in the overall cost of living.[1] Thus, by maintaining a constant commission rate over the period, real estate firms actually experienced an increase in realized price substantially greater than the increase in the overall rate of inflation.

An increase in price would not have occurred if active price competition had been prevalent in most local markets for real estate brokerage services. Demand for brokers, relative to the increase in supply that had developed over the preceding period, declined during 1979. In competitive markets, this softening of demand would tend to be associated with some decline in price for brokerage services. This was not observed in the sites for which we had longitudinal price data.

The existence of substantial commission rate uniformity over time and across localities for brokerage services, coupled with a history of the NAR's setting or recommending commission rates and the informal peer pressure to retain prevailing rates for sales involving an MLS, strongly suggests the absence of active price competition for brokerage services. This does not imply that competition does not exist among brokers, but that the primary methods of competition do not include lowering commission rates to increase market share. While some of the non-price competition techniques used by brokers include assistance with financing and other services thay may benefit the consumer, they also include the hiring of additional sales agents to compete for the available sales. As is discussed later, this factor can reduce industry productivity and would not be expected to benefit the consumer. At any rate, the practice of reducing the price of the service to the consumer does not appear to be a widely used technique to obtain his business.

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[1] See Chapter XV for the sources and derivation of these data.

EXHIBIT IX-4

NEGOTIATING WITH BROKERAGE FIRMS

Seller Knew Terms Were Negotiable:

Total	100.0%	(202 Respondents)
Yes	64.9%	
No	34.7%	
Don't Know	.4%	

Seller Tried to Negotiate Terms (of the 64.9%):

Total	100.0%	(131 Respondents)
Yes	46.6%	
No	53.4%	

Seller Was Successful in Negotiating Terms (of the 46.6%):

Total	100.0%	(61 Respondents)
Yes	82.0%	
No	14.8%	

Listing Agent Reduced Commission (of the 82.0%):

Total	100.0%	(50 Respondents)
Yes	42.0%	
No	58.0%	

SOURCE: PMM&CO. Seller Survey, February 1980.

Extent of Reverse Competition

The real estate brokerage industry is a logical marketing target for other providers of settlement services because of the broker's unique relationship with home buyers. While a more comprehensive discussion of reverse competition can be found in the title insurance and private mortgage insurance sections of this report, a few observations resulting from the buyers survey merit attention.

One of the primary ways buyers learned that they could shop for settlement services was through the brokerage firms with which they were dealing. Nearly 20 percent of the buyers interviewed said that they learned about shopping through their broker. This was the second largest response generated by the survey to the question of how respondents became aware of the opportunity for shopping (past experience was the first reason for 54.6 percent of the buyers).

The importance of the broker's position vis-a-vis the buyer also was confirmed by the responses obtained through the buyer survey. According to the buyers interviewed, 10.4 percent of the agents required the use of a particular provider and 60% of the agents recommended the use of a particular provider. We caution against the strict interpretation of the term "required," however, no proof can be offered concerning the strength of this requirement. Of more importance is the fact that the broker is in a position to suggest other providers.

Brokerage firms are most likely to require or recommend lenders, title insurers, and escrow companies. According to the buyers surveyed, of those who were required or recommended to the specific providers, the distribution of the types of providers is as follows:

	Agent Recommended or "Required" of 324 (70.4% of total)
Lender	75%
Title Insurance Companies	50%
Escrow Companies	44%
PMI Companies	36%
Attorneys	18%
Surveyors	26%

Additional evidence from the buyer survey in our eight market sites indicates that buyers rely on their brokers when selecting lenders and title insurance companies. Exhibit IX-5 indicates that when buyers were asked how they selected a lender, 39.5 percent stated that their agent told them which lender to use.

EXHIBIT IX-5

METHODS USED TO SELECT LENDER

Agent Told Respondent Which Lender to Use	39.5%
Personal Reference/Family or Friend Recommendation	8.0%
Professional Reference	6.8%
Phone Listings/Newspaper Ads	.2%
Had Past Dealings with Lender	10.5%
Assumed Mortgage/Loan	10.0%
Seller/Builder Specified Lender	11.5%
All Other	16.3%
TOTAL	100.0%
Total Respondents	410

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

While lenders were the most important buyer contact point for title insurance, brokerage firms also were important as insurance guides for home buyers. Of the 467 respondents, 136 (29.1 percent) said they were required to use a specific title insurance company and 162 (34.7 percent) said that specific title insurance companies were recommended to them. Of the 136 buyers that were required to use a specific title insurance company, 20.1 percent were so required by their real estate agent. Of the 162 buyers to whom a title company was recommended, 30 percent were given the recommendation by their agents. Finally, of the same 162 buyers, 33.1 percent said they used the lender's recommendation and 29.4 percent said they used the agent's recommendation. When buyers were asked how they learned about shopping for title insurance, only 5.6 percent responded they learned from their lender, while 33.3 percent learned from their agents.

REASONABLENESS OF PROFITS

The persistence of unusually high profits over time would tend to suggest that workable competition does not exist and that prices are excessive. However, the real estate brokerage industry cannot be characterized as an excessively profitable industry. Rather, industry profits are highly cyclical and vary as a function of individual firm performance. Further, firm profitability is limited by the ease of entry into the industry by new participants.

The primary source of industry financial data is the NAR reports on real estate brokerage income, expenses, and profits. This report, published annually since 1975, provides data for "the better than average" firms, according to explanatory notes in the report. Data are available for 1975 and 1977. Differences in financial performance for these periods are likely as a result of the markedly different economic conditions during these two years.

Exhibit IX-6 presents the available financial data for 1975 and 1977. One industry term, "company dollar," required definition. This term represents the sum remaining from gross income after all sales and listing commissions (including co-brokerage) have been distributed; it is, therefore, the amount of money available to the firm to pay its expenses and to distribute as profit.

A comparison of the 1975 and 1977 data demonstrates the cyclical nature of industry profits. While operating margins remained essentially constant over the two years, actual average net income[1] increased from $23,377 in 1975 to $29,348 in 1977. The difference (a 25.5 percent increase) is a function of the expanded sales volume in 1977 resulting from an improved economy. While better than the previous year, 1975 was a difficult sales year, as the recession limited buying activity.

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[1] Net Income is Pre-tax.

EXHIBIT IX-6

INDUSTRY FINANCIAL DATA FOR 1975 AND 1977

MEAN INCOME AND EXPENSES PER FIRM	1975	1977
Gross Income	$417,195	$549,774
Distribution of Fees and Commissions	$246,514	$325,054
Company Dollar	$179,823	$224,028
Expenses as a Percent of Company Dollar:		
Advertising	16.4%	16.7%
Sales Promotion	4.7%	5.2%
Sales Management	3.8%	4.4%
Salary of Personnel	14.1%	13.4%
Value of Owner's Services	14.2%	14.6%
Communications	6.1%	5.9%
Occupancy	9.3%	9.0%
Operating	17.5%	16.7%
Other	.9%	1.0%
TOTAL EXPENSES	87.0%	86.9%
Net Income as a Percent of Company Dollar	13.0%	13.1%
Actual Net Income	$ 23,377	$ 29,348
Actual Value of Owners Services (Non-selling)	$ 25,535	$ 32,708

SOURCE: "Real Estate Brokerage: Income, Expenses, and Profits" 1975, 1977. National Association of Realtors.

A second measure of profitability is the sum of the owner's managerial salary, commissions, and the firm's net income. For 1975[1] the average for each was $25,535, $12,465, and $23,377 respectively. Thus, the average total cash flow to the owners of brokerage firms was $61,377.[2]

While the owner's total cash flow appears to be a healthy sum, it is an average and does not reflect fully the operating characteristics of all firms. Rather, the industry's earnings varied broadly. Exhibit IX-7 provides a breakdown which more fully portrays industry financial characteristics. The exhibit illustrates that the lowest 10 percent of the firms lost at least $3,291 in 1975. In contrast, the top 10 percent had net incomes which exceeded $65,582. Owner's return, which includes pre-tax net income and the owner's salary, ranged from $2,218 (lowest decile) to $107,544 (highest decile). The broadest measure, owner's cash flow, varied from $7,079 to $130,740. Again, these statistics are based on a sample of "better than average" firms.

INDUSTRY PRODUCTIVITY

In a recent study commissioned by the NAR, the Arthur D. Little Company concluded that "salesperson transaction rates in the residential real estate brokerage industry (houses listed or sold per unit time per full-time equivalent salesperson) have been decreasing in recent years."[3] Declining productivity, as measured by transaction rates, is a major problem facing the industry. Its causes appear to be threefold:

- the continued increase in housing prices above the rate of inflations which encourage new entrance;
- the ease of entry of new firms into the industry; and
- the ease with which firms can expand market coverage by increasing salespersons in a limited market.

Economic theory can be useful in describing the causes and results of declining productivity in an industry such as this. In situations where prices are above competitive market levels (because of monopoly power, price

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[1] Data available only for 1975.

[2] The NAR report for 1975 indicates a sum of $59,689. We believe the difference is caused by a mathematical error in NAR's calculation of total expenses as a percent of company dollars.

[3] Arthur D. Little, Inc., The Challenge of Success - Issues, Expectations and Challenges Relating to the Future Environment for the Real Estate Industry, Acorn Park, Cambridge, Mass., November 1979, p.71.

EXHIBIT IX-7

NET INCOME, OWNER'S RETURN, AND OWNER'S CASH FLOW

	NET INCOME	OWNER'S RETURN	OWNER'S CASH FLOW
Lower Decile	-$ 3,291	$ 2,218	$ 7,097
Lower Quartile	$ 1,924	$ 12,740	$ 20,132
Upper Quartile	$ 31,998	$ 58,052	$ 74,345
Upper Decile	$ 65,582	$107,544	$130,740

SOURCE: "Real Estate Brokerage: Income, Expenses and Profits 1975," National Association of Realtors.

collusion, or other market imperfections) and where barriers to expansion and/or entry into the market are low, providers are likely to increase their supply of services (i.e., more salespersons) offered to the market. Concurrently, higher prices tend to reduce quantities demanded. Relative to what would exist in a competitive environment, these conditions are likely to produce an increased number of providers supplying a reduced quantity of services, or by definition, reduced productivity. Even with higher prices, profits may be no higher than if competitive market conditions prevailed because declining productivity reduces potential excess profits.

This economic model can be applied to the brokerage industry, as shown in Exhibit IX-8. Figure 1 depicts supply and demand curves for brokerage services at a given point in time.[1] As prices increase, the quantity of services supplied increase, and the quantity of services demanded decrease. If active price competition prevails, then the market price or commission rate is P1. If market imperfections exist and cause the prevailing commission rate to be higher, for example at P2, then a condition of excess supply exists--the quantity of services brokerage firms are willing to supply exceeds the quantity demanded. The difference in quantity is measured by the distance between points A and B in Figure 1.

This scenario describes what appears to occur in the industry. Market imperfections have prevented active price competition and have likely resulted in costs above competitive prices. To gain market share in this non-price competitive market, firms often increase their sales force, a typically easy task given the availability of part-time sales agents willing to work on a commission basis. This decision is not necessarily a function of the demand for services but of expected earnings relative to the expected cost of the additional sales agents. Despite the reduced probability of selling or listing a house, sales agents are motivated to accept these positions by the anticipated high commissions available when a house is sold. Because increases in housing prices have outstripped the overall rate of inflation and commission rates have not decreased, the real value of earnings from the sale of a house has increased and acts as an incentive to draw sales agents into the market, either on a part-time or a full-time basis.

In Figure 2, the relationship between commission rate and employment of salespersons is illustrated. At any point in time, the supply of salespersons is positively related to expected earnings. Expected earnings equal price times expected quantity of services sold. However, because the demand for brokerage services appears to be relatively price-insensitive (quantity demand declines only slightly as the commission rate is increased), the

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[1] For purposes of exposition, we assume the market is in equilibrium. That is, factors are not changing which would cause demand, supply or the price to change. In the real world, changes are often occurring and markets are often in flux.

EXHIBIT IX-8

INDUSTRY PRODUCTIVITY

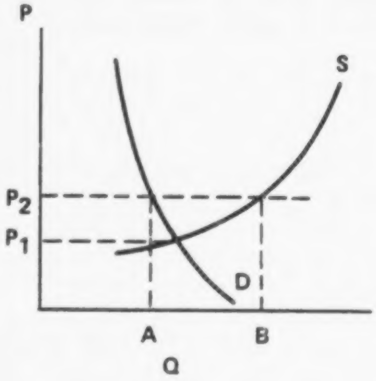

FIGURE 1

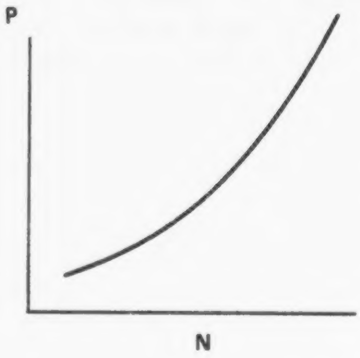

FIGURE 2

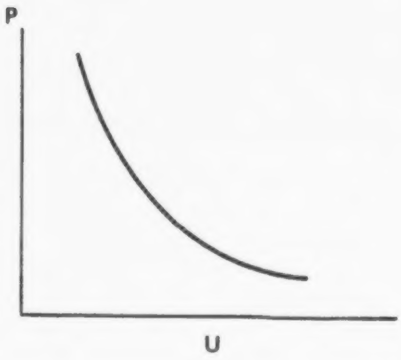

FIGURE 3

P = Real Estate Brokerage Commission Rates

Q = Quantity of Services

N = Number of Full-Time Salespersons

$$U = \frac{\text{Residential Units sold per person month of Salesperson}}{\text{Person-months}}$$

SOURCE: N. G. Miller and P. J. Sheed, "An Economic Explanation for the Uniformity of Real Estate Brokerage Fees, and Projections for Change", Department of Real Estate and Legal Studies, University of Georgia.

supply of salespersons also is expected to be related positively to the price of the services. Employment in the industry, therefore, would increase if commission rates increased. Figure 2, then, reflects an increased supply of salespeople motivated by high commission rates, competing for an externally determined quantity of listings and sales.

The positive relationships between price and the number of active salespersons described in Figure 2 results in the relationship between commission rates and units sold per salesperson person-months, illustrated in Figure 3. This relationship indicates that as commission rates increase, the number of houses per unit of provider input decreases. In simpler terms, this relationship results in lower productivity in the real estate brokerage industry.

It is difficult to test the hypotheses discussed in this section because of the lack of data available on employment in the industry. However, the discussion presented is entirely consistent with accepted economic theory. Further analysis must be based on data showing levels of transactions and employment and earnings related to different commission rates.

ADEQUACY OF REPRESENTATION FOR BUYERS

This issue does not relate to the price of the brokerage service but to its quality and appropriateness. Currently, the listing broker represents and is paid by the seller (and has a fiduciary responsibility to him) while the selling broker is legally a subagent of the selling broker, rather than a representative with fiduciary responsibility to the buyer. In practical terms, the legal subagency relationship may not be important in most cases involving cooperation among listing and selling sales agents, or the agents themselves may not be fully aware of the subagency relationship or fully understand its implications. However, the fact that the selling broker and sales agent are paid by the seller through the listing broker has important implications for how well the potential buyer is represented by what he perceives to be "his" broker.

The selling broker shares the commission if the buyer purchases a house that the broker shows him, but receives nothing if the buyer purchases a house shown him by another broker. Thus, the selling broker has a powerful financial incentive to ensure that a sale occurs on the house that he shows a prospective buyer. This allegiance to the sale may cause the selling broker to overstate the attributes and understate the deficiencies of a particular house, or to advise purchase even if he believes the house to be overpriced. In negotiating the price of the house and other terms of the sales contract, the buyer may be poorly represented by a broker who may tend to avoid seeking contract terms which could jeopardize the sale and his commission.

Most selling agents and brokers may in fact adequately represent the buyer's interests in showing houses and in negotiating terms of sale.

When asked about their level of satisfaction with their real estate agent, 65 percent of buyers indicated they were satisfied and 19 percent said they were somewhat satisfied. Only 16 percent responded that they were either somewhat disappointed or very disappointed. It is possible, however, that some satisfied buyers were not totally aware or thought about the implications of the payment mechanism for the selling agent and, in fact, perhaps were not well represented in negotiations with the listing agent. Clearly, some agents, responding to the structure of financial incentives, may do a better job of representing their own interests than the interests of the buyer, where those interest diverge.

CONCLUSIONS

A more comprehensive economic analysis is needed to reach a definitive conclusion about market performance in the brokerage industry. Our initial research plan called for such a level of analysis, but our investigation was limited by the lack of relevant industry data. The information that is available, however, suggests that active price competition in the industry is significantly constrained. We base this judgement on:

- the limited extent to which the criteria for sure competition are met;
- the existence of market imperfections which serve to constrain active price competition; and
- the evidence of significant price uniformity across different and changing market situations.

While factors which cause price rigidity can serve, in some market situations, to limit price increases. We believe that for the most part, these factors have caused prices to be higher than they would be in a more price-competition environment.

Though most industries cannot satisfy fully the four criteria of price competition, several factors in the brokerage industry significantly impede their being satisfied. Brokerage firms do not appear to act independently in establishing their pricing strategies. Rather, the historical evolution of industry pricing seems to influence current decisions, and to help maintain the current commission rate structure. Moreover, the mechanisms of the MLS and cooperative practices seem to encourage uniform pricing and serve as a monitoring device for member firms. In many instances, they may discourage firms from reducing commission rates from those prevailing in the area.

While barriers to entry are not significant for the traditional firm, the alternative firms we interviewed indicated that they experience difficulties. Inability to gain access to the MLS or membership in a local board are two barriers that prevent such firms from competing equally with other firms that are members. Both the MLS and board membership present greater barriers for those firms denied access than either licensing requirements or necessary start-up costs.

Issues of both pricing and productivity indicate that the industry does not operate in a very competitive manner. Based on the data available, our analysis indicates that, to a substantial degree, price uniformity exists within each market, across markets, and over time. The 6 or 7 percent price frequently charged in the markets studied does not appear to be market-determined.

Declining productivity is one indicator of an inefficient market. It results in higher prices than would be charged in a perfectly competitive market and limits profitability to the firm. It is caused, in part, by individual firm marketing strategies, the ease of entry into the market, and the commission rate pricing structure employed by the industry. It also results in a missallocation of financial resources. While adequate data were not available to satisfactorily test hypotheses regarding productivity, our analysis of available information suggests strongly that it is lower than would exist in a price-competitive period. While the market for real estate brokerage services is not characterized by active price competition, one point must be highlighted. Most consumers prefer to use a traditional brokerage firm to list and sell their homes. Consumer acceptance is an important indicator of market performance of the 83 percent of sellers who use brokerage firms, 94.1 percent used traditional firms. On their previous sale, 82.9 percent had used such firms. Thus, an overriding majority of sellers prefer to use a traditional firm.

Consumer satisfaction also is a key indicator of market performance. Of the sellers interviewed, 62.9 percent said they were very satisfied and 18.5 percent said they were somewhat satisfied. In contrast, less than 19 percent of the sellers were somewhat or very disappointed. In evaluating the listing and showing functions performed by the brokerage firm, most sellers and buyers registered satisfaction. Nearly 75 percent of the sellers said their listing price was accurate. Of the remainder, an equal percentage said it was either too high or low. Most sellers did not have to reduce their price to make a sale, and only 2.4 percent of the sellers received only one offer. These results suggest strong consumer satisfaction.

There is a question, however, of the adequacy of representation of the buyer by the selling agent, particularly in negotiating house price and terms of sale. This stems from the selling agent being paid (through the listing agent) by the seller and only if the sale is consummated. Despite this, our survey results indicate a high degree of buyer satisfaction with the service of their real estate agent.

Overall, then, the market is not characterized by active price competition or what we have termed workable competition; these are strong indications of market imperfections that seem to lead to higher prices. However, consumers are generally satisfied with the services received. It is therefore, necessary to conclude that market performance is mixed--not good or bad. Prices are likely higher and industry productivity is likely lower than they would be under active price competition. Yet, there is a high level of consumer satisfaction with services provided by the brokerage industry.

X. THE PERFORMANCE OF THE MORTGAGE LENDING PROCESS

The enactment of RESPA required that the residential mortgage lender assume significant compliance responsibilities: (1) distribution of both the special information booklet (SIB) and the good faith estimate (GFE), (2) advanced disclosure; and (3) retention of HUD-1 forms. These responsibilities primarily involve procedural changes and do not substantially impact the basic mortgage lending process. Categorically, mortgage lenders have described these changes as costly to implement, but it is less clear that they have resulted in an overall higher cost to the lending process. Part 3 of this volume evaluates the impact that RESPA has had upon the mortgage lending and other settlement-related processes. That discussion of impact considers changes in the lending function and evaluates mortgage lending from a perspective of pre- and post-RESPA procedures.

This chapter is concerned primarily with the economic performance of the market for the residential mortgage lending; that is, the extent to which the consumer is well served by being provided lending and ancillary services required for settlement at a reasonable cost.

To analyze this performance, we examine the mortgage lending industry by asking the following questions:

- To what extent are the conditions that define pure competition being substantially met?

- To what extent do available data on pricing of loans and lending related services suggest that active price competition or "workable" competition persists in these markets?

- Are these indications that the consumer is being provided with inadequate, inappropriate, or excessive services that may add unnecessarily to the cost of settlement or may be unresponsive to his needs?

In reading this chapter, a number of ideas that were developed in Part 1 should be kept in mind. The first reflects the major structural differences among mortgage lending institutions. These institutions primarily include mortgage bankers, commercial banks, and the traditional mortgage-oriented thrifts--mutual savings banks and savings and loan associations. Less dominant institutions include credit unions, life insurance and finance companies, and a range of other plausible sources of mortgage finance providers that fall under the category of "other". Each of these institutions, however, may be subject to substantially different federal and state regulatory requirements and may be motivated in part by substantially different incentives. Part 1 described the loan origination process as one designed to develop an investment portfolio (as is the case for most depository lenders) or a servicing portfolio (as is done by nearly all mortgage bankers). But in some situations; commercial banks perceive residential mortgage lending entirely as a customer service designed to attract or retain deposits or to attract other commercial lending business.

These differences in type of lending institution and in motivation to provide mortgage financing may make it difficult to make general statements regarding the overall performance of the mortgage lending marketplace. Further clouding an assessment of performance has been a number of developments that have substantially changed the way that many financial institutions do business. In a recent article in The Journal of Retail Banking[1], Mr. John G. Heimann, the Controller of the Currency, described three important ongoing trends among financial institutions that may bring about a major change in the way that they develop competitive advantages. He classifies these trends as: (1) a breakdown among geographic market barriers; (2) a disintegration of product market barriers; and (3) an erosion of interest rate controls. Each of these trends has a significant impact upon mortgage lending and upon likely changes in overall market performance. Each has allowed particular types of financial institutions to develop advantages in attracting both customers and deposits that were earlier unavailable. Each of these trends is discussed in greater detail as they apply to this consideration of economic performance.

A second important idea developed in Part 1 and critical to this discussion is the twofold settlement function that is performed by the mortgage lender. In one case, the lender provides funds to finance the home purchase by a borrower; in another case, he facilitates settlement by arranging for many of the other services or providers that he deems necessary. This second function is as much a product of the lender's fiduciary responsibility in making loans as it is of his ability to efficiently make recommendations or decisions and arrange for those services.

A third theme relates to the mortgage lending product. The borrower or consumer actually purchases both functions provided by the mortgage lender, i.e., the use of his funds and his efforts in taking application, evaluating, arranging for services, originating, and possibly marketing the loan to a permanent investor. Charges for both of these functions, however, are not entirely discrete. They may overlap and be expressed in any combination of mortgage rate, discount points, or other settlement-related charges accruing to the lender. This makes it difficult for the consumer to evaluate alternative costs of different mortgage lenders.

A final theme relates to the actual terms of the loan repayment agreement. At settlement, the consumer is concerned with neither the actual source of the borrowed funds nor with the identity of the eventual investor. Mortgage money is a fully fungible product; as a result, it is not the money itself, but the terms accompanying the loan that are of interest to the borrower, and they may be substantially different across mortgage lenders. This chapter develops the theme that the features of the loan agreement and the interest rate, points, fees, charges, and options or decisions placed in the hands of the lender define lending practices and represent important components of the total "price" of mortgage financing.

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[1] John G. Heimann, "The Realities of the Marketplace", The Journal of Commercial Banking, Vol. I, No. 3., December 1979, pp. 1-4.

These options or decisions are a very important part of the loan agreement, and they contribute significantly to determining whether a borrower's lending terms are favorable. Certainly the right to select (or reject) other settlement service providers has an important impact upon cost, and nearly all lenders exercise this right to some extent. However, even beyond the selection of a mortgage or title insurer or of a settlement attorney or escrow agent, other terms of the loan agreement are very important and may implicitly influence costs (i.e., the interest rate, points, fees, or charges).

Some of these options or decisions may include: (1) an assumability clause; (2) prepayment terms; (3) escrow requirements; and in some cases; (4) refinancing or interest rate adjustment provisions. These functions are significantly influenced by both custom and regulation, as well as by the market forces of supply (of funds), demand (for mortgage money), and levels of competition. They differ both across lender types and across geographic boundaries, and although they are a very important element of the mortgage lending product, they remain very difficult to comprehensively understand or evaluate.

This analysis of performance within the mortgage lending industry follows a format similar to that of other sections in this part of Volume II. It first considers the extent to which the requirements of pure competition are present. Second, it considers other criteria for determining the extent of workable competition within the industry, along with other criteria of acceptable market performance. Finally, this section draws conclusions concerning overall mortgage lending market performance in terms of those characteristics described in Chapter VII, and it considers the impact of such industry performance upon particular consumer interests.

ASSESSMENT OF EXTENT OF PURE COMPETITION

Chapter VII described a purely competitive market as characterized by four specific conditions or characteristics. With regard to the mortgage lending industry, these include: (1) product homogeneity; (2) an absence of significant market influence by any single buyer or seller; (3) total information regarding financing terms and loan characteristics readily available from all mortgage lenders; and (4) an absence of barriers preventing potential mortgage lenders from entering the industry or from leaving. Each of these is considered in turn.

Criteria 1: Product Homogeneity

Product homogeneity is important because it allows consumers to focus more easily upon price differences among products, rather than upon a host of distinguishing product characteristics. A consideration of product homogeneity requires consideration of both: (1) the use of funds and the conditions of the repayment agreement executed between lender and borrower; and (2) the efforts or service provided by the lender in helping to bring about settlement.

Chapter VII suggests that product homogeneity is a function of both product uniformity and of variation in the quality of that product. Variation in quality, however, is a less critical issue here than in other industries studied. Because from the perspective of either the borrower or the mortgage lender quality refers to the terms of an agreement or to services that are both required by and provided by the lender. As such, qualitative distinctions can be largely translated into a consideration of risk and return, and are then expressed in terms of interest rates, fees, and charges.

Conditions of Repayment Terms

As was mentioned earlier, mortgage money is fully fungible and entirely homogeneous; however, significant variation occurs in the definition of terms or conditions that accompany the repayment agreement. Mortgage lending, like almost all other commercial lending activities involves conditions that are defined in terms of a detailed analysis of risk and return. As a result, many terms or conditions designed to reduce a lender's risk will allow that lender to make available to a borrower a loan at a reduced interest rate. In other conventional lending arenas, lenders may require that specific debt:equity or debt service:income ratios be maintained. Within the realm of mortgage lending, the amount of down payment becomes a similar example of such a risk-reduction condition.

Almost all lenders will charge a higher interest rate to borrowers who provide only small down payments than to those who make larger down payments. This does not suggest an absence of produce homogeneity. In fact, a 95 percent LTVR loan is a significantly different type of loan than, for instance, a 75 percent LTVR loan, and each warrants a very different evaluation. The former suggests much greater risk for which the lender requires compensation in the form of a higher expected return. The two loans cannot be compared without acknowledging this basic distinction.

However, even among loans of a similar LTVR and an identical mortgage interest rate, major product heterogeneity may exist. As was briefly highlighted in the introduction to this section, this may take the form of whether: (1) a loan is assumable (with or without an adjustment of the mortgage rate to current market levels); (2) a prepayment penalty is imposed (a factor that protects the lender's interest during periods of declining interest rates); (3) escrow requirements are made for taxes and/or insurance; (4) refinancing options are allowed; (5) private mortgage insurance is mandated; or (6) standard loan application procedures are strictly followed.

This list is not an exhaustive one, but it suggests that a number of factors can influence uniformity in a loan agreement as well as a loan's desirability from the perspective of the borrower. Another controversial term or condition that can differentiate among financing terms is the commitment period within which the lender agrees to allow the borrower to go to settlement at a stated interest rate. Although not a part of the loan agreement, this can be a critical term of the financing arrangement. During periods of volatile interest rates, this term can be a very important to a borrower, particularly if he awaits completion of a newly constructed home. Delayed completion by the builder may force the borrower to forfeit a commitment and be subject to either additional charges or to a higher interest rate. Both additional costs could result in a borrower's no longer qualifying for a loan. This particular issue is discussed at greater length in a later part of this section.

Other situations that may influence differential conditions in a loan repayment agreement may include: (1) a current customer or important depositor relationship; (2) a business relationship; or (3) certain personal relationships. These reasons for favorable treatment exist, are admitted to, and can represent substantial benefit to those consumers able to secure such treatment.

All factors influencing the terms or conditions of the financing or repayment agreement substantially undermine product homogeneity in the true economic sense. Most unsophisticated mortgage loan applicants are unprepared to recognize or evaluate the benefit or cost of these terms; as a result, the terms are often not considered as differentiating factors. However, their existence makes much more difficult the task of comprehensively evaluating the relative merit of alternative lending terms, and substantially limits the perceived homogeneity of such terms.

Lender Provided Services

The price quoted for mortgage financing services is a combination of interest rate, points, fees, and charges; it reflects the services that a lender will perform as a part of the process leading up to settlement. What is contained within this package of services can vary greatly by both custom or tradition, by regulation, and by the incentives available to the lender to provide either more or fewer services. For instance, some lenders will perform settlement agent functions or require that their own attorney be present; some stated chartered S&Ls are allowed to self-insure certain high LTVR conventional loans; and some lenders may use their own staff to perform needed services that other lenders may contract for.

As a result, consumers may find that the services they are purchasing as a part of the mortgage financing package may indeed be very different and may frustrate attempts to do accurate comparative shopping. Some lenders may quote a "price" for financing services and then require that particular providers of additional services be used who may represent an additional marginal cost to the settlement process. Others may require that significant costs that are nonrefundable be prepaid at time of loan application; this decreases the consumer's interest in shopping and may represent an important "sunk" cost if for some reason the closing does not take place. All of these factors contribute to increasing produce differentiation and to eroding the ability of the marketplace to provide consistent and comparable information.

Summary

It is important to recognize that some repayment terms and some lender-provided services may be irrelevant or non-differentiating, depending upon both the individual borrower's needs and the conditions of the local market. For instance, for a household intending to purchase and occupy a home for a very long period (possibly 10 or more years), a number of specific conditions such as assumability, prepayment penalty, and refinancing options may be unimportant. The payment of discount points (which, when amortized over a long period become less "costly") is less critical, as are advantages which may accrue from a fixed rather than a renegotiable or variable mortgage rate. Similarly, if lender escrow requirements do not difer within an area, or if lender services are passed on to a borrower at the same cost as those that are independently contracted, then meaningful differences in the lending product become less pronounced.

Differences in both the terms of a repayment agreement and the packages of lender-provided services can represent an important absence of product homogeneity that impairs the ability of the consumer to shop and to purchase an adequate level of required services at a reasonable price. These differences, however, are more pronounced across geographic boundaries than within an area where custom and tradition often dictate product terms. However, even within markets where lending terms and services are nearly uniform across lenders, this lack of homogeneity places naive consumers at a disadvantage without substantial, detailed knowledge of mortgage lending practices by the average consumer, one can assume little product homogeneity within the mortgage lending process.

Criteria 2: Independently Acting Buyers and Sellers

The existence of pure competition or of conditions suggesting a highly competitive marketplace requires that no single (or small group of) buyers or sellers is able to influence market prices. Within the mortgage lending industry, three major factors define the extent of market influence. These are: (1) the number of active buyers or sellers; (2) the extent of concentration by buyers or sellers within a particular market; and (3) the extent to which buyers or sellers are able to influence market performance through either formal or informal collusion, an ability to fix prices, or withdrawal from the marketplace.

Number of Mortgage Lenders

Amont the five settlement service industries evaluated, the mortgage lending industry appears to present the most varied and institutionally distinct range of providers. The structure of the industry that is presented in Part 1 is a national composite of all primary mortgage lenders. Mortgage lending, however, remains essentially a local market process, and the varied national structure does not suggest that all areas of the country benefit from an equally broad range of lending institutions. Savings banks, for instance, are absent from most areas outside of the northeast (Seattle, Washington is a notable exception); commercial banks are not always active mortgage lenders because of their alternative avenues for lending or investment, and mortgage bankers (and branches of many depository institutions) tend to locate in areas of high mortgage origination activity.

These trends suggest that smaller metropolitan and rural areas may be at a disadvantage because of a limited number of alternative lenders. In earlier studies [1],[2],[3] some authors have concluded that mortgage interest does appear to be lower in large cities or urban areas than in small cities or rural areas. Those authors, however, acknowledge that other factors such as operating inefficiencies, limited economies of scale, or an absence of secondary marketing capacity may contribute to such interest rate variation.

Nevertheless, local mortgage markets have changed significantly during recent years due to an expanded and more efficient secondary market. This factor has particularly contributed to the erosion of geographic barriers that has isolated borrowers restricting them to a narrower supply of lenders and investors. Through branching activities, through correspondent relationships, and through the development of loan origination subsidiary units, lenders are now more able to enter markets that they might earlier have been ineligible to penetrate.

In view of this fact, it is apparent that local markets may vary significantly in terms of the number of active mortgage lenders. Each of the eight sites in which interviews were conducted were major metropolitan areas and therefore benefited from a large number of nearly all types of lenders. Our consumer interviews indicated that S&Ls and mortgage bankers were the most frequent sources of financing. These two types of institutions provided loans for nearly 80 percent of the 623 buyers sampled. Commercial banks were active lenders in all eight areas but accounted for only about 10 percent of all sources of mortgage financing. Mutual Savings Banks (MSBs) were present, however, in only four of the eight areas, and accounted for more than 2 percent of any SMSAs loans in only Seattle (where they represented 5.1 percent of the loans) and Boston (11.4 percent). For a detailed breakdown of lender type within each SMSA, see Exhibit X-1.

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[1] O. Jones and L. Grebler, The Secondary Mortgage Market, Real Estate Research Program, U.C.L.A., 1961, pages 24-25.

[2] W.W. Alberts and A.F. Jung, "Some Evidence of the Intra-regional Structure of Interest Rates on Residential Mortgage Loans," Land Economics, 46:208-213, May, 1970.

[3] M.O. Peterson, "Some Evidence on Intra-regional Differences in Yields and Costs of Mortgage Lending," Land Economics, 49:96-99, February 1973.

The exhibit demonstrates the role that mortgage bankers may plan in areas where local depository institutions are either inactive mortgage lenders or require too high a cost of funds. In both Jacksonville and Denver, mortgage bankers accounted for more than 70 percent of the loans among the sample, thereby filling a void left by local banks or S&Ls. These market intermediaries facilitate the movement of funds across local market areas, and make it more difficult for a small group of local institutions to dominate a large local mortgage market.

Local Market Concentration

The increasing liquidity that has developed in the secondary market and the role that mortgage bankers can play in directing foreign (i.e., non-local) funds to a local market area limit the ability of a small group of lenders to maintain major market dominance. Non-urban and rural areas may certainly be subject to greater concentration, but large metropolitan areas are not. Among the eight SMSAs that have been analyzed, we took a particularly close look at three segments of the Washington, D.C. market: the District of Columbia; Fairfax County, Virginia; and Montgomery County, Maryland.

Four-firm and eight-firm concentration ratios were calculated for these three areas and for the combined Washington, D.C.-Fairfax-Montgomery County area for both 1977 and 1979. Among these three areas, the District of Columbia evidenced the greatest concentration. In 1979, four firms accounted for 25.5 percent of all mortgage lending (32.1 percent in 1977), and eight firms accounted for 38.2 percent (44.7 percent in 1977). Montgomery County's four firm ratio was 22.5 percent in 1979, and in Fairfax County, the four largest lenders accounted for only 11.9 percent of all mortgage lending in 1979 (see Exhibit X-2).

These three areas illustrate very different levels of market concentration and in both Washington and Fairfax. The four and the eight-firm concentration firm declined substantially between 1977 and 1979. In Montgomery County these ratios increased but only slightly. These may reflect the national experience. It is known, however, that many urban areas have a large number of mortgage lenders with no single or small group of lenders having a dominant market position.

None of the observations in this two-year perspective indicated that eight firms accounted for even half the total lending. In the combined area in 1979, eight firms represented less than one-fourth mortgage total loans. While not reflecting the atomistic structure characteristic of perfect competition, these concentration ratios are not indicative of market domination by a few firms.

EXHIBIT X-1

SOURCES OF MORTGAGE FINANCING FOR BUYER INTERVIEWS, SELECTED SMSAs; 1979 - 1980

	COMBINED TOTAL	BOSTON	LOS ANGELES	SAN ANTONIO	D.C.	DENVER	ST. LOUIS	SEATTLE	J'VILLE
Savings & Loans	39.2%	54.4%	66.2%	22.7%	39.4%	19.5%	62.7%	37.2%	12.5%
Commercial Banks	10.3	17.7	14.7	6.7	11.3	2.4	13.3	7.7	8.8
Savings Banks	2.4	11.4				1.2		5.1	1.2
Mortgage Banks	40.4	6.3	19.1	56.0	39.4	73.2	16.0	41.0	70.0
Cash Purchases	2.7	5.1		1.3	2.8	3.7	1.3	1.3	6.3
Other	5.0	5.1		13.3	7.0		6.7	7.7	1.2
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT X-2

MORTGAGE LENDING CONCENTRATION WITHIN THE GREATER WASHINGTON, D.C. AREA 4- AND 8- FIRM CONCENTRATION RATIOS

1977 & 1979

(Percentage of Market Share)

CONCENTRATION RATIO	WASHINGTON, D.C.		MONTGOMERY COUNTY, MD		FAIRFAX COUNTY, VA		COMBINED	
	1977	1979	1977	1979	1977	1979	1977	1979
4 - Firm	32.1	25.5	22.1	22.5	12.6	11.9	18.4	15.0
8 - Firm	44.7	38.2	35.2	35.3	21.6	19.8	28.9	23.3

SOURCE: Kaplan, Smith & Associates, Inc.

NOTE: Mortgages included here are on single-family and multi-family residential property, commercial property and land loans.

Exhibit X-3 shows the distribution of mortgage lending by different types of lending institutions within the greater Washington, D.C. area. Different institutions captured significantly different shares of the total market in each of the three market areas, and between 1977 and 1979 the market shares underwent a substantial transition. For instance, savings and loans forfeited large portions of the proportionate lending market; mortgage bankers became much more prominent in the two surburban counties, and credit unions and "other" types of lenders made major increases ih their market position.

The rapidness of these changes demonstrates a lack of concentrated market influence by lender type, and the changes demonstrated by the concentration ratios suggest a highly decentralized market structure. There is no reason to believe that most major metropolitan areas within the country would evidence a significantly different pattern.

Collusion Within Lending Markets

The extent to which a group of lenders is able to influence market performance substantially limits the degree to which that market approaches pure competition. In the mortgage lending marketplace, information describing interest rates, points, fees, and charges is readily obtainable, although it may be somewhat difficult for consumers to evaluate. Lenders, however, are in a position to know exactly what their competitors are charging. In theory, this suggests a great difficulty in artificially maintaining price stability for mortgage financing services. In practice, the diverse structure and the relative lack of concentration demonstrated by this industry vis-a-vis other settlement-related industries suggest that collusive practices across lenders would be very difficult to maintain.

From an investment perspective, there is good reason to believe that collusion across lenders within a metropolitan area would be ineffective. As was explained in Part 1, mortgage interest rates are determined primarily by (1) the cost and availability of borrowed funds; (2) a cost of operations; (3) the return provided by alternative investments; and (4) credit market expectations. These first three influences may be nearly the same for some lending institutions (they often are not), but market expectations represent a very subjective factor that may encourage some lenders to raise or lower their rates while others may hold their rates constant. As a result, collusion assumes similar expectations and market control, neither of which are likely.

While our interviews and analysis offered no evidence that lenders in the eight metropolitan areas would find it desireable (i.e., profitable) to collude to maintain price levels for mortgage financing, significant examples were referenced that suggest that mortgage lenders are in a position to develop ties or controlled business relationships with other providers. Often these relationships result in greater efficiency or convenience in completing the entire settlement process, but they provide a potential opportunity for consumer abuses such as misrepresentation, the provision of inferior or unnecessary services, or higher charges to the consumer. Relationships with both attorneys and title insureres are discussed in Chapters V, VI, and XII.

EXHIBIT X-3

CONCENTRATION OF MORTGAGE LENDING WITHIN THE GREATER WASHINGTON, D.C. METROPOLITAN AREA BY LENDER TYPE 1977 - 1979

INSTITUTIONAL MARKET SHARE (PERCENTAGE OF MARKET SHARE)				
INSTITUTION	WASHINGTON, D.C.	MONTGOMERY COUNTY, MD	FAIRFAX COUNTY, VA	COMBINED
1977				
Savings & Loans	34.8	57.1	34.6	40.4
Commercial Banks	37.0	14.1	6.7	18.5
Mortgage Companies	16.0	22.7	46.1	30.3
Credit Unions	0.6	0.2	0.1	0.3
Others	11.7	5.9	12.7	10.6
1979				
Savings & Loans	26.4	41.7	23.8	28.8
Commercial Banks	37.6	13.3	6.8	19.4
Mortgage Companies	12.5	35.2	51.6	33.8
Credit Unions	0.8	0.6	0.8	0.7
Others	22.7	9.3	17.0	17.3

SOURCE: Kaplan, Smith & Associates

NOTE: Mortgages included here are on single-family and multi-family residential property, commercial property and land loans.

Summary

Sellers of mortgage financing services find it difficult to either overtly or covertly influence market conditions. This is partly a consequence of insufficient motivation to do so; investment funds in this country move efficiently through market intermediaries and into liquid, alternative forms. The large number of mortgage lenders present in most urban areas makes market influence difficult to achieve, as does the limited extent of concentration allowed lenders in most large local markets. Due in part to operational inefficiencies, marginal costs, and a scarcity of other lending institutions, rural areas are more vulnerable to market influence.

Criteria 3: Market Information

In a purely competitive market, both buyers and sellers are assumed to possess (or have access to) perfect information relating to price and product characteristics. This criterion is very much an abstraction -- no real marketplace has total information available to all parties. It is important, however in assessing competitive market performance, that one consider the extent to which buyers or sellers are injured by a lack of market information.

Knowledge of a borrower's credit worthiness that is not revealed in the ordinary credit investigation might substantially limit the number of bad loans that a lender might make. Knowledge of the actual life of a newly originated mortgage loan would allow a lender to more accurately determine a true origination yield. As a result, loans would not need to be priced by expected average prepayment assumption, and in individual cases, both lenders and borrowers would benefit.

Within the marketplace for mortgage financing, however, information is typically interpreted as that available to consumers. Part 1 indicated that most lenders are aware of the financing terms made available by their competitors. On the other hand, information available to consumers should be evaluated on two bases. First, is there relevant market information being withheld from consumers (or made difficult to access) that can result in some form of injury? Second, does a lack of understanding of market information cause the consumer damage? Answers to both these questions have a significant impact upon consumer interests.

In our extensive interviews with both consumers (buyers and sellers) and lenders, we were unable to identify any overt withholding of information concerning a lender's terms. In arranging for lending services, the consumer is principally required to assume responsibilities for locating acceptable financing. To do so, he typically relies on advice from sellers, brokers, friends, etc. or directing calls to alternative lenders. Sometimes the advice he is given may not be in his best interest; sometimes builders or brokers may have an economic incentive to "lead" buyers to particular lenders. However, there appear to be few instances where a lender would withhold information concerning interest rates or other important loan characteristics.

This appears to indicate that the market for mortgage financing does make available a large amount of information critical to selecting a lender. A significant shortcoming exists, however, in the ability of the average consumer or home buyer to knowledgeably shop for and compare financing terms. Nearly two-thirds of the lenders interviewed in the eight sample sites agreed that home buyers generally feel that all prices are the same, and an even larger proportion agreed that home buyers did not want to take the time to shop, did not know enough about settlement procedures to comparatively shop, or simply were willing to take the advice of other settlement providers.

The sample of lenders was asked to evaluate the extent to which the home buyer understands the home buying and real estate settlement process. Only 5.6 percent of the lenders described their customers as understanding the process "very well," 64.2 percent said that home buyers understand the process "somewhat well"; but 3 out of 10 lenders (30.2 percent) described their customers' level of understanding as not at all good. Exhibit X-4 illustrates differences in the lender's assessment of the borrower's understanding across SMSAs and by type of lending institution, and suggest that lenders in the Washington, D.C. area feel their borrowers understand the process least well among the eight sites. The complexity of the settlement process and the difficulty so many consumers have in becoming familiar with it is one of the most significant deterrents to shopping. Market information may be available to consumers, but unless it is delivered in a form that allows the consumer to take positive action, that information may be of less value.

These findings are reinforced by the interviews with more than 600 home buyers within the eight sites. When asked whether they had shopped for a lender, 64.4 percent indicated that they had not. The reasons for this lack of interest in shopping varied. Among buyers who did not shop, about 10.5 percent selected a lender with whom they had prior dealings; nearly 15 percent relied upon professional or personal references; 10 percent assumed an existing loan and felt they had no reason to shop. However, among this group that indicated they did not shop, a large proportion relied upon the professional recommendation or reference of other settlement service providers.

Nearly 40 percent of the respondents selected the lender to whom the real estate broker had directed them, and another 11.5 percent used a lender specified by the seller or builder. This suggests that the availability of market information is not critical to many buyers in selecting a mortgage lender, but it does not entirely answer the question of whether a lack of understanding of market information contributed to some degree of damage to the consumer. Only about 12 percent of those who did not shop admitted that they felt all lending institutions were similar, and about 7.7 percent simply said they did not have time to shop.

Both of the consumer samples indicated rather significant inter-regional differences in the extent to which home buyers shopped for lending services. The combined average for the initial consumer interview indicated that 35.6 percent of the consumers shopped; across the sample of buyers who participated in the second set of (telephone) interviews, 34.1 percent shopped for lenders.

EXHIBIT X-4

ASSESSMENT BY LENDERS OF BUYER UNDERSTANDING OF THE SETTLEMENT PROCESS
(SELECTED SMSAs AND LENDER TYPES; 1979 - 1980)

(Percentage)

LENDER ASSESSMENT OF BUYERS UNDERSTANDING	COMBINED TOTAL	BOSTON	DENVER	W.D.C.	J'VILLE	LOS ANGELES	SAN ANTONIO	ST. LOUIS	SEATTLE
'Very Well'	5.6	8.6	7.5	0	0	12.9	5.1	2.9	7.1
'Somewhat Well'	64.2	65.7	57.5	51.7	81.3	54.8	76.9	61.8	60.7
'Not At All Well'	30.2	25.7	35.0	48.3	18.8	32.3	17.9	35.3	32.1

	COMBINED TOTAL	COMMERCIAL BANK	S&Ls	MSBs	MORTGAGE BANKS
'Very Well'	5.6	10.8	5.9	5.3	1.2
'Somewhat Well'	64.2	55.4	67.6	78.9	63.4
'Not At All Well'	30.2	33.8	26.5	15.8	35.4

SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT X-5
SHOPPING BEHAVIOR AMONG HOME BUYERS BY SMSA

SMSA	PERCENT OF BUYERS WHO SHOPPED FOR A LENDER	PERCENT OF BUYERS WHO SHOPPED, WHO FELT SHOPPING WAS WORTHWHILE
Initial Consumer Interview		
Boston	71.6 %	79.3 %
Los Angeles	46.4	72.4
San Antonio	21.8	76.5
Washington, D.C.	38.7	75.9
Denver	21.7	83.3
St. Louis	44.0	72.7
Seattle	32.1	88.5
Jacksonville	9.6	62.5
Combined Average	35.6	78.0
Subsequent Telephone Interview		
Phoenix	18.5 %	90.9 %
San Francisco	43.8	96.3
Atlanta	23.9	62.5
Chicago	64.3	83.3
Louisville	33.9	100.0
New Orleans	33.3	78.9
Las Vegas	13.1	87.5
Newark	49.2	86.7
Philadelphia	46.0	72.4
Nashville	18.0	81.8
Combined Average	34.1	84.1

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

However, within each of these sets, responses varied from as few as 9.6 percent shoppers in Jacksonville and 13.1 percent in Las Vegas, up to 64.3 percent in Chicago and 71.6 percent in Boston. (See Exhibit X-5.)

Significantly greater agreement among buyers was demonstrated in the extent to which they felt their efforts were worthwhile. Among the first sample of consumer interviews, 78.0 percent of the shoppers felt that their shopping was worthwhile; among the second group, 84.1 percent admitted that shopping for a lender was a worthwhile activity. Exhibit X-5 shows unanimous agreement on the value of shopping from buyers in Louisville, and in Las Vegas, Phoenix, Seattle, and San Francisco, seven out of eight shoppers for a mortgage lender felt those efforts were rewarded.

These data indicate that available market information can be accessed in many metropolitan areas across the country, and that the comparative shopping that was made possible by such information can benefit the consumer. The ability to find and use available information is one element of a highly competitive marketplace. Another is the extent to which interplay between buyer and seller results in negotiations over price and terms of the product. Lenders interviewed in the eight sites were asked to estimate the proportion of customers who attempted to negotiate prices or services. They indicated that over 27 percent of their customers attempted to negotiate price-selected factors, but that customers were successful in such negotiations only about 4.6 percent of the time. (See Exhibit X-6.)

Responses to the initial interview of home buyers indicated that buyers have somewhat greater success in negotiating conditions of their financing agreement with a lender. Among all home buyers interviewed, 14.2 percent indicated they were able to negotiate aspects of the mortgage interest rate; 9.7 percent said they were able to negotiate the number of points they were charged, and as many as 17.6 percent said they were able to negotiate with the lender the maturity or term of the loan. Exhibit X-7 indicates that there is substantial variation across sites in the success that loan applicants are able to achieve. It appears that negotiating is particularly effective in Los Angeles, St. Louis and Boston, and much less effective in Seattle, the District of Columbia, and San Antonio.

Summary

These results strongly indicate that adequate market information is available to those home buyers who assume responsibility for seeking it. They also suggest that a significant population of home buyers have achieved worthwhile results through shopping for alternative mortgage lenders. A relative degree of success in negotiating with lenders has been demonstrated in a number of market areas, and this type of frequent interchange between buyers and sellers is highly suggestive of a competitive market environment. In view of these observations, it appears that the necessary characteristics relating to market information that distinguish a competitive marketplace, are available to purchasers of mortgage financing, but the difficulty of interpreting and comparing prices quoted for this product places the consumer at a considerable disadvantage.

EXHIBIT X-6

LENDER ASSESSMENT OF FREQUENCY OF CUSTOMER NEGOTIATION (SELECTED SITES; 1979-1980)

	PERCENT OF CUSTOMERS ATTEMPTING TO NEGOTIATE RATES/SERVICES	PERCENT OF TIME RATES/SERVICES WERE CHANGED AS A RESULT OF CUSTOMER NEGOTIATION
Combined Total	27.4 %	4.6 %
Boston	20.5	5.0
Denver	33.0	4.1
Washington, D.C.	42.9	4.9
Jacksonville	19.2	3.3
Los Angeles	27.5	5.3
St. Louis	33.7	3.6
San Antonio	24.9	9.3
Seattle	15.6	1.7

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

EXHIBIT X-7

EXTENT CONSUMERS ACKNOWLEDGED NEGOTIATING LOAN CONDITIONS (SELECTED SMSAs: 1979 - 1980)

	LOAN CONDITIONS		
	INTEREST RATE	NUMBER OF POINTS	MATURITY/TERM OF LOAN
Combined Total	14.2 %	9.7 %	17.6 %
Boston	17.7	14.1	24.4
Denver	13.4	11.0	14.6
Washington, D.C.	11.3	5.8	11.3
Jacksonville	4.9	5.1	17.1
Los Angeles	24.2	23.9	23.5
St. Louis	22.7	10.8	32.0
San Antonio	7.7	5.3	11.5
Seattle	4.9	2.6	10.0

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

Criteria 4: An Absence of Industry Barriers

The primary barrier to entry into the mortgage lending industry relates to regulatory requirements. For many mortgage lending institutions, barriers occur in the form of capital requirements, state or federal charters, and the maintenance of reserves and other asset and performance requirements that are established by certain regulatory bodies with responsibility for all depository institutions. Even mortgage banking firms (considered the least regulated of all mortgage lending types) must fulfill requirements of this nature in order to maintain their status as "approved" FNMA seller services, or as approved correspondents for other institutional investors.

Although such requirements do represent actual barriers to entry, they are established and enforced out of a desire to maintain consumer confidence in the ability of these institutions to act both as depositories and as fiduciaries. Each traditional mortgage lender fulfills a role that is much broader in scope than simply providing funds for the purpose of residential mortgage lending, and further eliminating some existing barriers might substantially undermine some of those other institutional purposes.

It is fair to comment, however, that barriers that have distinguished or separated the mortgage market from other financial markets within this country (i.e., the markets for equities and for corporate, government or agency debt) have become much less pronounced during the past decade. As a result, the residential mortgage market has been able to sustain a rate of growth that has significantly exceeded that of other debt sectors (see Appendix B).

At the practical level, this change has allowed local S&Ls and local commercial banks access to new sources of funds in order to supplement local mortgage. Lending credit unions, which five years ago could not provide mortgage financing, now can. More importantly, the increasing liquidity and fungibility of mortgage assets has allowed mortgage banking operation to locate in areas where depository institutions are unable to adequately serve all potential mortgagors -- this has significantly reduced geographic barriers influencing mortgage lending.

Some geographical boundaries yet exist, and may be particularly noticeable in considering intra-regional yield differentials between urban and non-urban areas. [1] However, even these types of barriers can be gradually reduced by an increasingly efficient secondary mortgage market that will allow funds from even a broader range of institutions to be invested in residential loans.

This absence of effective barriers, however, allows lenders and investors equal ease in directing funds out of the mortgage market. S&Ls and to a lesser extent, savings banks are required to maintain a high proportion of their assets in mortgage investment. Commercial banks, however, and many of the institutions to whom mortgage bankers sell loans, can lend or invest in a variety of other investment forms. As a result, such an absence of barriers has made the mortgage market both more fluid and efficient but also more vulnerable to changes in national credit market conditions.

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[1] Op. Cit., Jones and Grebler; Alberts and Juns, and Peterson.

Summary

Three of the four preliminary conditions for pure competition appear in the mortgage lending industry to be ratified to a reasonable degree. The one economic condition that is least well defined is that of product homogenity. Differences in the mortgage product among lenders, some of which are hard to evaluate without a considerable investment in time on the part of the borrower has likely contributed to the frequent occurrence of selecting a mortgage lender through the process of referral, rather than through knowledgeable market scrutiny.

CRITERIA FOR EVALUATING WORKABLE COMPETITION

While pure competition is not likely to be achieved in any settlement service market, nor indeed in most other product markets, it is critical to an evaluation of market performance to seek to determine if workable competition exists. Where workable competition prevails, suppliers of services would be forced by the pressures of a price competitive market to provide their product or service at a price which is close to the lowest possible cost of production.[1] As discussed in Chapter 3, the criteria for workable competition cannot be precisely defined, but they include some degree of satisfying the four conditions for pure competition, evidence of competitive pricing among providers, and other indications that servicers are being provided efficiently and at reasonable cost.

Price Variability

At the outset, it is important to indicate what degree of price variation is consistent with workable or active price competition. Assume for the time being that the market is in equilibrium and the product is homogeneous. In the case of mortgage loans, a single market interest rate is consistent with perfect competition, also with perfect collusion. On the other hand, wide variation in interest rates suggests consumer access to certain providers, or other factors which discourage consumers from seeking a loan from the low interest rate providers. This obviously does not suggest workable competition and good market performance.

A narrow range of prices, if other indications of market competitiveness are present, would tend to suggest workable competition. This range may be somewhat wider and still be consistent with workable competition if there was some product differentiation or if the market was not in complete equilibrium, i.e., money market conditions changing.

In an earlier section, it was pointed out that a contract mortgage interest rate is one of the most important elements in the cost of mortgage financing. It is also, however, one of a number of elements in the cost, any one of which can be of significance to a borrower depending upon his needs and expectations. To comprehensively evaluate price variability, all of the elements of cost ought to be considered. At a practical level, this is difficult to accomplish, due to differences that may exist within the financing product and to different subjective values consumers may impute to specific terms or conditions.

In this section, a number of assumptions are made in order to quantitatively evaluate price variability from the perspective of only two of the cost elements--the contract mortgage rate and the number of points that are charged the consumer. It is necessary to assume that with the exception of these two elements, the terms and conditions of mortgage financing alternatives that are compared are entirely homogeneous. That is, all financing products include exactly the same components of lender provided services; all prepayment penalties (to the extent they exist) are equal; there are no interest rate adjustments; all points and additional stated cash requirements are paid by the buyer; and no other factors differentiate the cash flow schedule accruing to the lender from the borrower.

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[1] This would include a market rate of return on investment, or profit.

Holding these elements constant, we have compared "effective interest rates" across a sample of lenders in order to determine the extent of variability that may occur at a given point of time within certain major metropolitan areas. That effective interest rate has been defined in terms of an origination yield which includes both: (1) the quoted contract or mortgage interest rate, and (2) the fees or points that may be charged by the lender as part of his commitment process.

It is important to clarify the meaning of these fees or points. Many lenders will assess borrowers' one-time charges at closing in order to increase the lender's yield on the mortgage loan to some level above the contract interest rate. However, as Part 1 explained, lender practices may differ significantly with regard to both the amount of these charges and the time at which their payment is required. They may be called loan fees, application fees, commitment fees, or simply "points," and these charges may be expressed as either a flat fee, a percentage of the loan amount, or some combination.

Determination Of Sample

Sample data describing contract mortgage rates, fees, and points for different categories (by LTVR) of loans were originally intended to be collected as a part of the primary lender interviews within all eight SMSAs. During the time of our interviews, however, credit market conditions underwent rather severe fluctuations, and sent the mortgage market into considerable confusion. Many lenders responded by withdrawing temporarily from the real estate lending, and others simply would agree to lend only at such high interest rates, indicating in effect that they also were ostensibly out of the lending market.

This has made it difficult to meaningfully interpret much of the "price" data that had been collected during the lender interviews that took place between December 1979 and February 1980, and it has encouraged us to find supplemental data describing lending terms within certain SMSAs. We have relied upon mortgage market data collected by two firms that compile and publish such information for primarily industry use. These firms maintain market information for the Atlanta, Washington, D.C., Los Angeles, and Seattle SMSAs. In some situations, these firms have developed a data base for up to three years; in most cases, however, the data have been available for a relatively short time. The reports we have used in the subsequent analysis and the firms publishing them are:

- Interest Data Reports,
  Published by Victor Peeke & Associates, Inc.

16011 Comus Road
Clarksville, Maryland
(Data include Atlanta, Los Angeles, Washington, D.C.); and

- The Bulletin
  Scottsman Publishing Company
  P.O. Box 30549
  Seattle, Washington
  (Seattle SMSA only).

We have collected market data for the four SMSAs as of two different points in time: (1) January 23-24, 1980, and (2) May 22-23, 1980.[1] These dates were selected because complete market data were available for all four sites only since the beginning of 1980 and because we wished to avoid the February through April period during which interest rates rose rapidly before settling to a level of relative stability. These two points in time are not intended to represent any kind of market normalcy in the sense of that which was maintained during the 1950s through the early-1970s, or as recently as 1976-1977. However, they do demonstrate the kind of dynamics that can occur within a local market over time, and they indicate that different areas may respond differently in terms of available financing alternatives.

Variations In Effective Interest Rates

Within these four SMSAs, we were able to evaluate lending terms for more than 180 different lenders, and nearly 160 lenders at a common point in time. To maintain comparability, we focused only upon lending terms for 80 percent LTVR loans. All fees and charges were discounted into an effective interest rate by using a standard 12 years prepayment assumption for a fully amortizing 30-year loan. In some instances (frequently in Los Angeles) where a flat fee was charged a borrower, a $75,000 conventional loan was assumed.

This information is summarized in Exhibit X-8, which contains aggregate data for all leaders within each of the four cities. The number of observations or number of lenders surveyed on a particular day varies from 21 in Washington, D.C.,[2] up to 63 in Los Angeles. The lenders include a selected but non-random range of active mortgage lenders within each site. Attempts were made by the publishers of these date to be comprehensive, but commercial banks

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[1] We would have liked to expand our sample to more than four sites. However, data were not available from bank regulatory authorities or other sources on mortgage interest rate variation within localities at given points of time. The data suggest that mortgage lending market characteristics tend to be relatively similar across localities and that our findings regarding interest rate variation in these four cities are generalizable to other large urban areas.

[2] These represent lenders in the District of Columbia only and do not include Virginia or Maryland suburban lenders.

EXHIBIT X-8

SUMMARY OF VARIATION IN CALCULATED, EFFECTIVE INTEREST RATES FOR SELECTED SMSAs, JANUARY AND MAY 1980

	ATLANTA	WASHINGTON, D.C.	LOS ANGELES	SEATTLE
January 23-24, 1980				
Mean Effective Interest Rate	12.766 %	13.257 %	13.179 %	12.438 %
Standard Deviation	0.377	0.370	0.250	0.707
Range	12.250-13.719 %	12.241-13.849 %	12.688-14.314 %	11.568-13.324 %
High-Low Spread	1.469 %	1.608 %	1.627 %	1.774 %
(No. Observations)	(41)	(24)	(63)	(31)
May 22-23, 1980				
Mean Effective Interest Rate	13.114 %	13.262 %	13.228 %	13.391 %
Standard Deviation	0.511	0.266	0.421	0.470
Range	12.500-14.177 %	12.582-14.028 %	12.730-14.864 %	12.540-14.356 %
High-Low Spread	1.677 %	1.446 %	2.134 %	1.816 %
(No. Observations)	(41)	(21)	(44)	(27)

SOURCE: Interest Data Reports (Victor Peeke & Associates);
The Bulletin (Scottsman Publishing Co.), and
PMM&Co.

were included only in Los Angeles and Seattle, and no savings banks were present in any of the samples, (within this sample MSBs operated only in Seattle, but during the times that prices were selected, the savings banks had reputedly withdrawn from active lending).

Exhibit X-9 shows that across each of eight observations (four sites; two different points in time), a rather significant range of "effective interest rates" (i.e., contract interest rates adjusted for points, fees, and charges) was available from alternative lenders. In no case was this differential (i.e., the spread between the high and low effective yield) less than 1.44 percent, and within the Los Angeles area during May 1980, two lenders were quoting terms that translated into effective interest rates that differed by as much as 2.13 percent. The distribution of quoted "prices" for mortgage financing across the eight observations illustrated standard deviations of between 25 basis points (one quarter of one percent) and .71 percent. The standard deviation across the eight observations averaged more than 40 basis points and was greater than 70 basis points in Seattle during late January.

This variation appears to indicate that rather significant benefits can result from shopping for mortgage financing terms. Exhibit X-10 considers these effective interest rate differentials from another perspective. The data presented there represent the range in monthly mortgage payments (i.e., payments of principal and interest) that would result if no points or other such fees were charged a borrower, and instead the lender's origination yield became the contract mortgage rate paid by the borrower. That is, the difference in monthly payments is based upon two distinct $75,000 loans--one made at a contract interest rate at the high effective yield found in each local area, the other made at the low effective yield. As the exhibit shows, in no set of observations is the difference due to different effective yields less than $85.00; the average across the eight observations is nearly $100.00, and in one situation is as high as $126.33.

The effective interest rate summarized in Exhibit X-8 is broken out in greater detail in Exhibits X-9 and X-10, where the data for each market area are subaggregated by type of lending institution. These data appear to indicate no specific behavioral patterns that significantly distinguish types of lending institutions. Mortgage bankers demonstrate the smallest combined standard deviation. This may be due to their ability to more quickly and more accurately reflect national market conditions. However, no type of institution demonstrates consistently higher effective interest rates.

On January 23-24, there was less than 16 basis points difference among the three Seattle lender groups; less than 13 basis points difference among the three Los Angeles lender groups; less than one basis point difference between S&Ls and mortgage bankers in Washington, D.C., and only in Atlanta did the difference between lender groups account for as much as 50 basis points. The May data indicate considerably more variation among Seattle (76.7 basis points) and Los Angeles (62.4 basis points) lenders; more but still very little variation in Washington, D.C. (10.1 basis points), and slightly less variation in Atlanta.

EXHIBIT X-9

EFFECTIVE INTEREST RATE SUMMARY DATA FOR FOUR AREAS DURING JANUARY 23-24, 1980

LENDER TYPE	ATLANTA	WASHINGTON, D.C.	LOS ANGELES	SEATTLE (JAN. 18-24)
MORTGAGE BANKERS				
No. of Observations	28	11	24	22
Mean (%)	12.909	13.261	13.209	12.429
Standard Deviation	.358	.412	.291	.760
Range (%)	12.250-13.719	12.241-13.849	12.856-14.315	11.568-13.342
High-Low Spread (%)	1.469	1.608	1.459	1.774
SAVINGS & LOANS				
No. of Observations	13	13	31	7
Mean (%)	12.413	13.253	13.134	12.457
Standard Deviation	.194	.348	.238	.527
Range (%)	12.250-12.750	12.835-13.849	12.688-13.784	12.031-13.323
High-Low Spread (%)	.500	1.014	1.096	1.297
COMMERCIAL BANKS				
No. of Observations	0	0	8	2
Mean (%)	NA	NA	13.263	12.582
Standard Deviation	NA	NA	.119	1.075
Range (%)	NA	NA	13.030-13.377	11.822-13.342
High-Low Spread (%)	NA	NA	.347	1.520
TOTAL				
No. of Observations	41	24	63	31
Mean (%)	12.766	13.257	13.179	12.438
Standard Deviation	.377	.370	.250	.707
Range (%)	12.250-13.719	12.241-13.849	12.688-14.315	11.568-13.342
High-Low Spread (%)	1.469	1.608	1.627	1.774

SOURCE: Interest Data Reports (Victor Peeke & Associates);
The Bulletin (Scottsman Publishing Co.); and
PMM&Co.

EXHIBIT X-9 (Continued)

EFFECTIVE INTEREST RATE SUMMARY FOR FOUR AREAS DURING MAY 22-23, 1980

LENDER TYPE AND STATISTIC	ATLANTA	WASHINGTON, D.C.	LOS ANGELES	SEATTLE (MAY 23-29)
MORTGAGE BANKERS				
No. of Observations	30	8	20	19
Mean (%)	13.243	13.200	13.188	13.200
Standard Deviation	.490	.158	.298	.374
Range (%)	12.500-14.177	12.962-13.342	12.730-14.151	12.540-13.849
High-Low Spread (%)	1.677	.380	1.421	1.309
SAVINGS & LOANS				
No. of Observations	11	13	21	6
Mean (%)	12.761	13.301	13.260	13.792
Standard Deviation	.405	.316	.387	.524
Range (%)	12.500-13.750	12.582-14.028	12.784-14.289	13.089-14.356
High-Low Spread (%)	1.250	1.446	1.505	1.267
COMMERCIAL BANKS				
No. of Observations	0	0	3	2
Mean (%)	NA	NA	13.742	13.025
Standard Deviation	NA	NA	.973	.269
Range (%)	NA	NA	13.118-14.864	12.835-13.215
High-Low Spread (%)	NA	NA	1.746	.380
TOTAL				
No. of Observations	41	21	44	27
Mean (%)	13.114	13.262	13.228	13.319
Standard Deviation	.511	.266	.421	.470
Range (%)	12.500-14.177	12.582-14.028	12.730-14.864	12.540-14.356
High-Low Spread (%)	1.677	1.446	2.134	1.816

EXHIBIT X-10

COMPARISON OF MONTHLY PAYMENTS FOR A $75,000 CONVENTIONAL LOAN WITH A CONTRACT RATE EQUAL TO HIGH AND LOW EFFECTIVE INTEREST RATES, JANUARY AND MAY, 1980

	ATLANTA	WASHINGTON, D.C.	LOS ANGELES	SEATTLE
January 23-24, 1980				
Payment at High Effective Interest Rate	$872.00	$879.70	$907.33	$848.68
Payment at Low Effective Interest Rate	785.92	785.42	811.40	746.61
Difference in Monthly Payment	$ 86.08	$ 94.30	$ 95.93	$102.07
May 22-23, 1980				
Payment at High Effective Interest Rate	$899.17	$890.32	$940.18	$909.83
Payment at Low Effective Interest Rate	800.44	805.22	813.85	802.77
Difference in Monthly Payment	$ 98.73	$ 85.10	$126.33	$107.06

SOURCE: PMM&CO., 1980.

Summary

In terms of our earlier discussion of extent of interest rate variations, the observed variation may be loosely thought of as moderate; it clearly does not reflect narrow variation, nor might it be considered wide. It is important to note some characteristics of the data and of prevailing market conditions during the periods when the surveys were made. While the January 23-24, and May 22-23, 1980, periods preceded and followed respectively the period of sharply rising and then sharply falling interest rates, they were not periods of stability and complete equilibrium in the money markets. Thus a portion of the observed interest variation may reflect some disequilibrium in the money markets. Second, we do not know if these lenders quoting rates at the bottom and top of the range were only marginally active or "heavy" lenders during the two periods. Last, there may be some product variation among lenders which may account to some extent for the observed interest rate variation. It is for these reasons that we interpret the average standard deviation of 40 basis points as reflecting "moderate" interest rate variation. In our view the interest rate data neither strongly support nor weaken the notion of workable competition or active price competition prevailing in these markets.

The Conditions for Reverse Competition

A second factor that is key to an evaluation of practical or workable competition is the extent to which the market for mortgage financing services operates in the presence of third parties who do not participate directly in the mortgage lending function. The mortgage lender often plays a critical role in selecting other settlement service providers, and that role is discussed within some of the other provider sections in this chapter. However, it is less clear whether the mortgage lender is typically selected through a process of reverse competition, i.e., by other providers; to the extent that he is not, and direct shopping for lenders prevails, greater levels of workable competition exist within this marketplace.

Available data suggest that the conditions for a highly competitive market do exist. In most areas, no lender or small group of lenders is able to exercise influence or control; a large amount of market information is readily available to those borrowers who would shop, and the industry is relatively free of barriers that would limit firms from entering attractive market areas. Despite this structure of the marketplace, we have found that a significant portion of buyers does not actively shop, and instead allow themselves to be directed to specific mortgage lenders by other providers.

It was earlier mentioned that nearly 65 percent of the home buyers interviewed responded that they did not shop for a mortgage lender. Among this group, more than half used either: (1) the lender to whom the real estate agent had directed them, or (2) the lender specified by the seller or buyer. Agent referral accounted for nearly 40 percent of the lenders selected by buyers who did not shop.

This suggests that at the practical level, a significant amount of lender selection results from a process that can be loosely characterized by the phrase "reverse competition." This is not a result of the structure of the lending industry; rather, it appears to be due to consumer reluctance to make inquiries and/or decisions relating to a subject with which they may be relatively unfamiliar. This incidence of reliance upon a real estate agent points to the rather important role played by the agent in arranging for the full range of settlement services.

Like so many other situations where responsibility is transferred by a consumer to a third party, the agent is placed in a position whereby he may potentially take advantage of the consumer. It is appropriate here to comment on the ability of the agent to responsibly lead the consumer-buyer to the best possible financing terms that are available. Typically the agent (or his firm) is very familiar with local mortgage market conditions and is able to identify the mortgage lender who can make the best terms available to a borrower. By relying upon the agent's knowledge and familiarity, the borrower may be able to save himself much search time.

However, no data are available which indicate whether lenders referred by real estate agents were actually those with the best available financing terms.

The agent should be in a position to make that decision, but some agents may be inadequately informed and some may "lead" borrowers to lenders to whom the agent has "always" referred borrowers. As a result, customary referral procedures may be inadequate to assure a complete flow of market information, and as a result of the traditional role fulfilled by agents in directing home buyers to sources of financing, some economic damage in the form of higher costs may result.

Other Criteria Of Workable Competition

Other factors that are relevant to an evaluation of the existence of workable competition within a marketplace include evidence of the persistence over time of: (1) unusually high profits, and (2) inefficient production. Within the marketplace for mortgage financing services, neither of these factors appears particularly pronounced, and the relative absence of both suggests that the forces of workable competition are somewhat prevalent among mortgage lenders. This is, however, a general statement that applies to the industry as a whole. Although we were unable to find indications of significant excess profits as low productivity, some lenders may be able to derive significantly high profits and tolerate production inefficiencies. Such performance, however, is more often allowed by an institution's cost of funds, rather than by its investment yield.[1]

It is important to note that mortgage lending institutions can be categorized as two very distinct types. Most are depository institutions whose profitability is determined by the "spread" or difference between a mortgage or other investment portfolio and the "cost" of funds, which is typically accounted for by customer deposits and other borrowings. For depository institutions operating within an area with a number of other lenders, profitability is determined by an ability to manage both a debt portfolio and an asset or loan portfolio.

Mortgage banking firms represent the second type of lender. These institutions are less able than many depository institutions to maintain either unusually high profits or production inefficiencies because they have no capital of their own to invest in mortgage loans, but must rely upon the movement of investment capital within the secondary mortgage market. Any ability they may have in particular areas to originate unusually high yielding loans will be quickly eroded as other mortgage banking or lending institutions become attracted. Mortgage bankers often argue that their profitability is more stably provided out of servicing income than by the fees they earn in originating mortgage loans. Sometimes they may benefit from a windfall gain resulting from holding an unsold inventory of closed loans during periods when interest rates fall, but this is a speculative gain that may as likely be lost during periods when interest rates rise.

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[1] This could be consequence of competition for savings deposits rather than poor performance in the mortgage lending market.

It is important to recognize that mortgage lending is not a discrete investment practice, but rather it represents a point on the continuum of many investment alternatives. As a result of an efficient secondary market, investment funds may move into and out of the mortgage market as the level of mortgage yields shifts relative to those other alternatives. At the secondary market level, the mortgage market moves more efficiently than it does at many local levels, and unusually high, available mortgage yields will attract investment funds that will push up the price for those mortgages and thereby bring down mortgage yields. The efficient movement of investment funds through the financial markets allows unusually high profits on mortgage investment to be kept to a minimum.

This continuum of investment alternatives is less available to thrift institutions than to commercial bankers and the investors represented by mortgage bankers. Savings and loans and, to a lesser degree, mutual savings banks are required to maintain stated portions of their assets in mortgage investments. As a result, they cannot take advantage of more profitable alternatives, and during periods when they experience significant increases in their average cost of borrowed funds, these institutions that are locked into long term mortgage investments may be at a greater disadvantage than their loan customers.

The market for mortgage financing sources is not characterized by the traditional elements of inefficient production. There is little advertising (and much less for attracting loan customers than for attracting deposits), and no evidence of other significant marketing costs in attracting borrowers. The availability of the secondary market and of alternative financial markets suggests that excess capital can be immediately invested elsewhere, and an increasing dependence upon automated procedures (for credit reports, underwriting procedures, appraisal verifications and servicing) has made mortgage lending an ostensibly more efficient process.

It should be noted that the existence of excess or unusually high profitability is difficult to measure in the mortgage lending industry, and no formal analysis was undertaken. The reasons include: (1) the nonprofit, mutual ownerships characteristic of many savings and loan organizations and savings banks; (2) the multiproduct nature of many financial institutions that engage in mortgage lending; and (3) the decentralized character of the industry.

Nevertheless, the existence of numerous lenders in most cities, the relatively nonsubstantial barriers to entry into the industry, and the relatively low price-earnings ratios typical of publicly traded lending institutions all combine to suggest that the industry is not characterized by unusualy high profits.

In this study, no formal attempt was made to determine the level of productivity in and efficiency of the mortgage lending process. However, there is little overt indication of mortgage lending and related services being provided in an inefficient manner. To the extent that active price competition exists in the mortgage lending market, lenders are under competitive pressure to provide services efficiently.

It is clear, however, that lenders feel compelled to either bring in house those services typically provided by others but which might be more efficiently provided by the lender, or to the consumer (or select) those providers who are least costly. This indeed is part of the rationale for "lender-pay" discussed in Volume III.

In summary, we were able to find no evidence suggesting that excessive profits were available within any of the large metropolitan areas we visited. In theory, such profits might be available in dominant lenders within small market areas. However, available literature that attributes higher mortgage yields to loans originated in these areas does not allow them a high enough premium over nonrural loans to represent excessive profits. Neither these high profits nor elements of production inefficiencies characterize the market for mortgage financing services.

Extent of Workable Competition

As indicated earlier, the criteria for workable competition are neither precise nor quantifiable. Yet the evidence from the numerous criteria suggests that workable or active price competition does exist to a reasonable extent in mortgage lending markets in the larger urban areas. Typically there are numerous independently acting providers, significant barriers to entry do not exist, and relevant market information is available though not always sought by borrowers. The product may not be homogeneous and may be difficult to compare across providers, but even this may not be a significant problem within a single market area. Our analysis of pricing behavior of lenders within markets is ambiguous, although it may be considered slightly supportive of active price competition if we consider that product differences and perhaps the disequilibrium of the market may be responsible for some incremental interest rate variation. Finally, there is little indication of the persistence of either unusually high profits or significant production inefficiency that may be consistent with excessive prices and little active price competition. The evidence is, therefore, supportive of a workable or active price competition.

High levels of workable competition are, however, not sufficient to define overall, acceptable market performance. The next section looks at some of the issues that define, along with evidence of workable competition, acceptable performance and situations that may place the consumer at a notable disadvantage.

DETERMINING ACCEPTABLE MARKET PERFORMANCE

Acceptable market performance can be defined as the extent to which the consumer is being provided with the services he needs at a reasonable cost. Cost and efficiency of production clearly are important components of market performance but so is appropriateness of services and the incidence of provider abuses that may stem from the consumer's being at a disadvantage because of lack of adequate information or for other reasons. In this section, the latter elements of market performance are analyzed.

Determining whether market performance is acceptable is clearly very subjective. The market performance of utility companies, for instance, may be considered inadequate by some critics, but the performance must be evaluated from the monopolistic or oligopolistic industry structure within which utility companies operate. In a similar fashion, the mortgage lending process should be evaluated in terms of the industry's structure and its methods of operations. Many issues relating to acceptable market performance are not being evaluated in categorical terms of "good" or "bad"; as a result, they will be considered largely in terms of costs or benefits that accrue to the consumer of mortgage lending services. In this section, market performance will be considered in terms of: (1) appropriateness of services; and (2) the extent and impact of tied relationships. The section concludes with an overall assessment of the market performance of the lending industry.

Appropriateness Of Services

No market as broad and diverse as that for mortgage financing services will function without claims of injury or damage. Often the definition of such injury or damage is inexact. Some borrowers may feel injured by late payment of prepayment penalties, or by the fact that escrowing or impounding is still allowed some lenders. There are four examples of market behavior that we feel qualify as possibly being inappropriate; these include: (1) lenders requiring non-essential services; (2) the use of pre-closing commitment terms that may restrain a borrower from establishing more exact mortgage payment or settlement cost estimates; (3) lender self-insurance; and (4) lender policies regarding the termination of mortgage insurance.

Non-Essential Service Requirements

Earlier discussions in this section and in Part 1 have described secondary market investors as the source of many settlement service requirements. A condition necessary to an efficient secondary market is fungibility or uniformity across individual mortgage loans. Mortgages, therefore, forfeit uniformity when a significant amount of discretion is given a lender concerning: (1) the need for a property appraisal or survey; (2) variations in the traditional underwriting process; or (3) the need for quality insurance or legal procedures. As a result, the secondary market has established certain minimum "confining" requirements that have become necessary conditions for the origination of nearly all mortgages.

This does not suggest that particular conditions may be less essential to portfolio lenders with no interest in marketing loan production to other investors. Most depository lenders have categorically adopted secondary market standards as minimum requirements for loans that they hold in their own portfolio in order to: (1) increase the overall quality of those loans, and (2) have such loans marketable and available for resale should conditions warrant that action. There are, however, particular requirements that may not be necessary on a case-by-case basis (for instance, appraisals or surveys when recent ones are available or the opinion of a second attorney to review work performed by an attorney whom the borrower selects).

In some instances, less costly or less comprehensive services may be adequate to maintain the minimum requirement or "confirming" nature of a mortgage loan. These instances relate primarily to the delivery of title and legal services and are addressed more thoroughtly in Chapter XII.

Commitment to Fund Terms

An earlier part of this section described the commitment as a very important part of the financing arrangement agreed upon by lender and borrower. During periods of relative interest rate stability, a lender may be able to promise the borrower an indefinite commitment period, that is, the lender is able to commit himself to providing mortgage financing at a specified set of points and contract mortgage rate. If the date of settlement is delayed for some reason (difficulty by a buyer in selling his own home, delayed completion of a new home for the buyer, etc.), the lender may be only inconvenienced and may suffer no economic loss as a result of the delay. In such cases, commitments would be extended for four months or more, or escrow indefinitely.

The significant changes and fluctuations in mortgage rates that have occurred during the past two years have made the issuance by lenders of commitments to fund a very risky market activity. If interest rates fall between the time that a commitment is issued and the settlement date, borrowers are often in a position to demand a lower rate or to go to another lender who is offering a lower rate. It is mandatory that declines between commitment and settlement dates in the FHA and VA ceiling rate be passed on to the borrower, and conventional lenders are also under some pressure to reduce their rate or terms when market rates have declined.

Alternatively, market interest rates may rise between the time of commitment issuance and settlement, and under such circumstances the lender is typically required to absorb the market risk. Mortgage bankers (and other sellers to the secondary market) may limit their risk to interest rate changes by securing commitments to sell loans to other investors. Those commitments, however, are also for a stated term, and if a loan cannot be closed and delivered within that time, the commitment may be forfeited and the lender may be forced to sell the loan to another investor at a loss.

In practice, the duration of that commitment has become a very sensitive issue to mortgage lenders; depending upon their expectations of interest rate movements, they may make available only very short commitments, or commitments to fund only at the prevailing market rate at the time of settlement. This shifting of risk to the borrower could cause him significant problems during periods of rising interest rates and reduced availability of mortgage funds. Substantially higher interest rates at the time of settlement would result in sharply higher mortgage rates and for some, loss of eligibility for the loan. For those that have sold their existing home, this loss of eligibility can be catastrophic.

Answers to the home buyer interviews indicate an array of lender practices in making commitments. It is noteworthy that the responses were from home buyers who had gone to settlement during a period that spanned much of 1979 and into 1980. They do not, therefore, represent practices at a point in time but over an extended period that includes one of sharply rising interest rates. Exhibit X-11 shows that across all eight SMSAs, 57.3 percent of the buyers received a written commitment stating contract interest rate and fees at the time of or prior to loan approval. However, 8.8 percent of the respondents did not know of their specific terms of financing until one week or less prior to settlement, and 2.3 percent of the respondents were unaware of specific financing until the actual day of settlement. More than 11 percent of these borrowers became aware of their financing terms far too late for them to shop and when it may have been too late to recognize whether they could reasonably offer such terms.

Among the more than 600 consumers interviewed, 10.6 percent indicated that points were added or their interest rate was increased at settlement beyond the "price" that had been previously quoted them. Members of this group were probably victims of market rate fluctuations and they, rather than their lender, absorbed the cost of those changes.

Lender Self-Insurance

Some mortgage lenders are not required to have private mortgage insurance coverage for all high LTVR loans that they hold in their portfolio. As an option, they may reserve one percent of the outstanding loan amount until such time as that loan is liquidated or possibly until it is reduced to an 80 percent LTVR loan. This option can be relatively attractive to the mortgage lender who decides to self-insure; he will typically charge the borrower a premium over the market interest rate in an amount about equal to that of private mortgage insurance premiums.

Lenders may also agree to charge the borrower a slightly high interest rate and to then pay the private mortgage insurance premiums as a normal operating expense. This practice is similar to the first, but allows the lender greater latitude in terminating mortgage insurance coverage and in continuing to collect a higher mortgage coupon rate. Lenders in our sample indicated that in each case, the average interest rate premium was one-quarter percent (although two respondents indicated a premium of 40 basis points, and 50 basis points, respectively).

EXHIBIT X-11

TIMING OF RECEIPT OF A WRITTEN COMMITMENT AMONG BORROWERS WHO DID RECEIVE SUCH NOTICE (SELECTED SMSAs; 1979 - 1980)

TIME WRITTEN COMMITMENT WAS RECEIVED	COMBINED TOTAL	BOSTON	LOS ANGELES	SAN ANTONIO	W.D.C.	DENVER	ST. LOUIS	SEATTLE	J'VILLE
Before Loan Approval	2.1%	4.0%	– %	2.2%	1.9%	2.0%	3.3%	1.9%	– %
At Time of Loan Approval	55.2	68.0	56.5	54.3	48.1	64.0	54.1	37.7	52.6
More Than 1 Week Prior to Settlement; After Loan Approval	20.1	24.0	26.1	19.6	16.7	20.0	16.4	22.6	18.4
Within 1 Week of Settlement	8.8	2.7	10.9	4.3	16.7	2.0	13.1	11.3	5.3
On Day of Settlement	2.3	–	–	6.5	5.6	–	1.6	3.8	2.6
Other	13.6	1.3	6.5	13.1	11.0	12.0	11.5	22.7	21.1

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

Among our surveyed mortgage lenders, 21.2 percent indicated that they had self-insured or paid for the mortgage insurance premium themselves by charging an interest rate premium to the borrower. This practice was most frequent in Seattle and San Antonio (in both cases, 40 percent of the lenders followed such a practice) and in Boston (one-third of the lenders). Across types of lending institutions, about one out of three thrifts either self-insured or paid for mortgage insurance themselves, but mortgage bankers rarely adopted such a practice (see Exhibit X-12).

Whether this represents inappropriate market behavior depends greatly on the actions of the borrower. He may be indifferent to whether that premium is paid to a private mortgage insurer or to the lender in the form of a higher yield. In fact, the premium becomes a legitimate interest and, therefore, a deductible income tax expense when no mortgage insurance policy is taken. It may be in his interest to so pay it.

Problems arise, however, because the premium is locked into the contract interest rate for the full term (typically 30 years) of the loan, whereas mortgage insurance premiums are typically terminated at the time that the loan balance reduces to 80 percent of original value. For a 12 percent 30-year loan, this typically happens during about the seventeenth or eighteenth year of the loan. At lower interest rates, a loan may amortize to 80 percent of its principal balance somewhat sooner (for a 9 percent loan, this would happen during about the thirteenth year).

Other difficulties in comparing these two alternatives include evaluating: (1) the value of the tax benefit; (2) the terms of the specific mortgage insurance payment plan that is being considered, which may include large premium prepayments at time of settlement and subsequent payments that reduce annually as the outstanding loan is repaid; and (3) the borrower's own "internal" discount rate. Under most circumstances, we would conclude that the consumer is at an advantage when his lender chooses to self-insure. Without the tax benefits, the borrower is typically required to pay less at settlement and it is not until very late in the life of the loan that the self-insured option becomes more costly.

A related issue addresses those situations where a lender terminates insurance coverage but continues to charge the mortgage for premium payments. Lenders acknowledged that this happended but that such a practice was not widespread. The mortgage insurance industry disapproves of this practice because it not only cuts into their business, but it exposes lenders to a level of risk that they may not be able to support. From a consumer perspective, this practice appears to be a misrepresentation on the part of the lender, and the lenders claim upon the premium for the self-insurance he provides does not appear legitimate.

Cancellation of Mortgage Insurance

Under nearly all circumstances, lenders are responsible for decisions concerning the duration for which mortgage insurance is required. The FHA

EXHIBIT X-12

PERCENT OF LENDING INSTITUTIONS INTERVIEWED WHO EVER SELF–INSURED OR PAID DIRECTLY FOR MORTGAGE INSURANCE COVERAGE (SELECTED SMSAs: 1979 - 1980)

	COMBINED TOTAL	BOSTON	LOS ANGELES	JACKSONVILLE	W.D.C.	DENVER	ST. LOUIS	SAN ANTONIO	SEATTLE
Lender Admitted to Self-Insuring or to Paying Directly for Mortgage Insurance	21.2%	33.3%	27.8%	6.9%	9.1%	0 %	40.0%	40.0%	14.3%

	COMBINED TOTAL	COMMERCIAL BANKS	S&Ls	MSBs	MORTGAGE COMPANIES
Lender Admitted to Self-Insuring or to Paying Directly for Mortgage Insurance	21.2%	23.1%	34.3%	33.3%	1.2%

SOURCE: PMM&CO. Lender Survey, February 1980.

insurance policy requires that premiums be paid for the full life of the loan. Conventional mortgage insurance, however, can be terminated at any time by the lender, the insurers themselves have no influence over this decision. As a result, some questions have been raised concerning a lender's requirement for mortgage insurance after it may no longer be needed or desired.

The concept of mortgage insurance is a relatively sophisticated one; few consumers are familiar with its details or options, and it is often purchased after little or no discussion of its terms. About one-third of the consumers surveyed bought private mortgage insurance, but only about 55 percent of this group indicated that some discussed mortgage insurance with them in any detail. Typically this person is the lender (37.3 percent of the time), although it was often the real estate agent (36.4 percent) or the attorney (15.5 percent). (See Exhibit X-13.) Among those instances where mortgage insurance could be terminated were discussed less than 40 percent of the time. Policy prices and their differences were considered more important, and were discussed with consumers.

The complexity of all settlement procedures in general and of mortgage insurance requirements in particular has allowed little attention to be paid to the details by which a borrower's payment for insurance coverage can be terminated. As a result, many lenders adopt rather strict policies regarding requirements that must be fulfilled if coverage is to be terminated. In our interviews with mortgage lenders, 13.0 percent responded that the policy must run a stated minimum term, but there was substantial disagreement over the length of that minimum term. Nearly half of the responding lenders (47.2 percent) indicated that the policy would terminate at the time (or at the end of the year during which) the loan amortized to 80 percent of its original appraised value; 27.1 percent of the respondents, however, allow cancellation at the time the loan is prepaid to 80 percent of a current appraised value (see Exhibit X-14). Other lenders indicated that the decision rests with the secondary market investor to whom the loan has been sold or that other, more discretionary policies are followed. Such policies may include a lower loan-current market value ratio, a favorable repayment history, or a deposition relationship with the borrower.

Inequities appear to develop in those cases where a mortgagor is required to continue paying mortgage insurance premiums even after significant property appreciation has occurred. For borrowers, whose lenders allow cancellation based upon a loan-to-current market value ratio of 80 percent or less, the cost is that of a new appraisal. Our respondents indicated a range of costs for this service of $30-$150; the modal response was $100. For many borrowers able to cancel their insurance, this may represent a front-end charge that is less desirable than continuing to pay monthly insurance premiums (particularly if they are part of the interest rate and are therefore deductible).

Other borrowers who must wait for their loan to amortize (or be prepaid) down to an 80 percent loan to original value ratio may be at a greater disadvantage, but conservative lending practices argue that such a requirement by the lender may not be unreasonable. Legitimate opinions state that property appraisals represent only an estimate of market value and that a property's appreciation may not be irreversible. In other words, values that go up may come down.

EXHIBIT X-13

FREQUENCIES DESCRIBING USE AND DISCUSSION OF MORTGAGE INSURANCE (SELECTED SMSAs; 1979 - 1980)

	PERCENT OF ALL RESPONDENTS WHO BOUGHT PRIVATE MORTGAGE INSURANCE	PERCENT OF INSURANCE BUYERS WHO DISCUSSED MORTGAGE INSURANCE WITH SOMEONE	PERCENT OF BUYERS DISCUSSING MORTGAGE INSURANCE WHO DISCUSSED THESE FACTORS:		
			PRICE	POLICY DIFFERENCES	CANCELLATION
	(1)	(2)	(3)	(4)	(5)
Boston	25.6%	56.0%	100.0%	54.5%	20.0%
Los Angeles	31.3	29.4	100.0	40.0	20.0
San Antonio	27.0	63.2	70.0	40.0	20.0
Washington, D.C.	41.7	65.5	84.2	31.6	38.9
Denver	49.3	40.5	85.7	58.3	38.5
St. Louis	37.5	70.4	94.7	52.9	47.4
Seattle	32.1	56.0	100.0	53.8	61.5
Jacksonville	31.0	59.1	84.6	76.9	41.7
Combined Total	34.7	55.2	89.6	52.4	39.2

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

EXHIBIT X-14

LENDER POLICIES WITH REGARD TO CANCELLATION OF MORTGAGE INSURANCE COVERAGE (SELECTED SMSAs: 1979 - 1980)

POLICY FOR ALLOWING MORTGAGOR TO CANCEL MORTGAGE INSURANCE COVERAGE	PERCENTAGE OF RESPONDING LENDERS FOLLOWING POLICY
Policy Must Run a Minimum Term	13.0 %
Policy Terminates When Loan Balance Amortizes to 80 Percent of Original Appraised Value	47.2
Policy Terminates When Loan Balance Amortizes to 80 Percent of Current Market Value	27.1
No Established Policy/Decision in Hands of Final Investor/Other	12.7

SOURCE: PMM&CO. Lender Survey, February 1980.

Many secondary investors follow this conservative logic and their services require mortgage insurance until the 80 percent of original value ratio is fulfilled. The Mortgage Corporation, for instance, stands by this somewhat conservative requirement, but FNMA follows a more flexible plan and allows coverage to be terminated if requested by a mortgagee who can present a recent appraisal demonstrating less than an 80 percent loan-to-current market value ratio.

It appears that some compromise would be in order to both meet conservative lender interests and to relieve consumers of paying for unnecessary insurance coverage. A lender's position that increases in property values are not irreversible is a sound one. It is possible, and even likely in very active real estate markets, that speculative interest may bid up housing prices beyond their economic value. This can result in substantial reductions in appraised value. However, a position requiring insurance cancellation based upon a conservative 67 to 70 percent loan-to-current market value ratio appears sound and would be in the consumer's interest.

A final issue with regard to mortgage insurance policy cancellation addresses the use of the proceeds of unexpired prepaid insurance premiums. Mortgage insurers typically require that all premiums be prepaid annually. If a policy is terminated prior to its anniversary date, a refund of the insured premium is due to the mortgagor. Insurers indicate that such refunds are typically sent directly to the mortgator, but in some cases they go to the lender. The lenders we interviewed said these refunds are either sent directly to the mortgagor, or are deposited in an escrow account and comingled with other balances.

However, the mortgagor may be unaware that his prepaid mortgage insurance represents an asset or a balance that is rightfully his, and some lenders may take advantage of this situation by withholding these prepaid items. This is particularly relevant in those situations where a home buyer has entirely prepaid his insurance premium for up to 12 or 15 years at time of closing. This may have represented a cost to him of as much as 2.5 percent of the loan amount, or $1,500 for a $60,00 loan. Should that home buyer sell his home or otherwise prepay his loan, after, for instance. two years, he is due a substantial premium refund.

Most insurers follow what is called a Short Rate Cancellation Schedule that is relatively consistent throughout the industry. This schedule calculates the extent to which prepaid premiums are recognized as earned. In the case of a 15-year policy that is terminated after two years, 65 percent of the prepaid premium would be unearned and therefore returned to the lender or mortgagor. This represents a refund of $975 that could, in effect, be due the borrower by the lender.

Our interviews indicated that prepaid or single premium policies are becoming less and less common, but a similar problem can occur for policies that are prepaid annually. If a policy requiring a 0.25 percent renewal fee (nearly standard throughout the industry, but for a more detailed discussion, see Chapter IV on mortgage insurers) for a $60,000 loan is terminated four months into a new year, then the Short Rate Cancellation Schedule allows insurers to recognize 44 percent of that years premium as earned. The remaining 56 percent or $84,00 (i.e., 56 percent of $60,000 x .0025) then will be returned to either lender or mortgagor.

This represents a substantially smaller sum than the unearned premium that would result from a single premium policy, but it nonetheless is a balance to which the consumer has a legitimate right. In those instances when a home is old or the loan is prepaid early in the first year, the refund amount could be even twice as much. Although fraud or misuse of these funds is possible, we were unable to establish that it represented a significant or common problem. The most effective preventive measure may take the form of raising consumer awareness, but in at least one state (Virginia) a bill has been proposed to the General Assembly requiring that unused premiums be returned to "the person paying the premium, or other person entitled thereto."[1]

The Extent and Impact of Interlocking Relationships

The structure of the mortgage financing industry has a significant impact upon market performance. Part 2 of this volume described the real estate settlement process as one inolving many details and the close coordination of many participants/providers. In such a situation, it is not uncommon for "preferred" relationships to develop. Trust and confidence in the work performed by other providers are essential to a smooth and timely loan closing. As a result, it becomes both convenient and efficient for mortgage lenders to recommend and sometimes require specific providers.

Development of Preferred Relationships

Preferred relationships are common in all industries, but they pose a problem for the lender because, through a set of transactions characterized by reverse competition, he is often responsible for selecting providers for whom the consumer will bear the cost. The frequency with which consumers are "guided" by lenders to specific providers was explored in the home buyer interviews. Across all eight SMSAs, 24.3 percent of the buyers indicated that their lender required the use of particular providers. This occurred most frequently in Boston, where 50 percent of the buyers were required to use some specified providers; in Los Angeles and Washington, D.C., however, particular providers were required of less than 9 percent of the buyers (see Exhibit X-15). In nearly an equal number of situations (24.4 percent), lenders had recommended that buyers use particular providers.

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[1] Commonwealth of Virginia, H. B. 546, Chapter 1, Tit. 6.1, Sect. 1.1-2.10.

EXHIBIT X-15

FREQUENCY WITH WHICH BORROWERS WERE DIRECTED BY LENDERS TO PARTICULAR PROVIDERS

	COMBINED TOTAL	BOSTON	LOS ANGELES	SAN ANTONIO	D.C.	DENVER	ST. LOUIS	SEATTLE	J'VILLE
Required Use of Particular Providers	24.3%	50.0%	8.7%	27.4%	8.6%	36.7%	23.0%	18.4%	18.9%
Recommended Use of Particular Providers	24.4	22.4	29.0	20.5	17.1	30.4	23.0	30.3	27.0
Did Not Refer or Direct to Particular Providers	51.3	27.6	62.3	52.1	74.3	32.9	54.1	51.3	54.1
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

The frequencies presented in Exhbit X-15 are explored in greater detail in Exhibit X-16, which describes the frequencies with which particular providers are required, and in Exhibit X-17, which describes how often they are recommended. These exhibits suggest that practices with respect to preferred relationships differ rather significantly across market areas. However, title insurers were by far the most frequently required and the most frequently recommended providers. Among the five providers, mortgage insurers were the least frequently required but were very often recommended (54.1 percent of the time that a borrower had providers recommended to him by the lender, a mortgage insurer was among the group recommended). These exhibits demonstrate the high frequency of times that a lender takes a position in requiring or requesting that particular providers be used.[1]

By themselves, these practices do not suggest that inequities are at work within the marketplace. In fact, some very sound arguments are posed in defense of these referral patterns. However, a market that is characterized by this behavior may tolerate consumers abuses when preferred providers are able to charge consumers relatively higher prices. Such abusive practices may be particularly easy to emerge where lenders are able to tell borrowers that "all providers cost the same." This poses a problematic situation that may not be solved by legislation (which may similarly outlaw legitimate and efficient preferred relationships); rather, the most practical solution may again be a knowledgeable and inquisitive consumer who is cautioned to shop for services.

Development of Interlocking Relationships

An important distinction exists between a preferred and a tied relationship. The former suggests that the interest of the consumer is subjugated to the lender's interest in efficiently completing the loan to settlement. The lender may be insensitive to the need for arranging for all services at the lowest possible cost to the borrower. An interlocking relationship, on the other hand, suggests that lenders and other providers can mutually benefit from referring or using one another's services. Preferred relationships may lead to interlocking relationships, but they need not necessarily.

The lending responsibilities in arranging for service providers allow extensive tied relationship and controlled business relationships to develop. These are not inherently bad or harmful to the consumer, but they represent potential abuse. On the positive side, real estate agents may exclusively direct their home buyers to certain lenders. These lenders may reciprocate by assuring the agent of available mortgage money, most attractive commitment

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[1] Consumer responses and lender responses differed. For example, 40.7 percent of the lenders surveyed indicated that they required the use of a specific attorney to at least review work performed by other attorneys. See Chapter XII for a full discussion.

EXHIBIT X-16

FREQUENCY WITH WHICH PARTICULAR PROVIDERS ARE REQUIRED OF BUYERS

	PERCENT OF BORROWERS WHOSE LENDERS REQUIRED CERTAIN PROVIDERS	PERCENT OF TIME REQUIRED PROVIDER WAS THE:				
		ATTORNEY	MORTGAGE INSURER	TITLE INSURER	ESCROW AGENT	SURVEYER
Boston	50.0%	89.5%	21.6%	51.4%	30.6%	43.2%
Los Angeles	8.7	16.7	66.7	83.3	100.0	16.7
San Antonio	27.4	73.7	63.2	84.2	73.7	68.4
Washington, D.C.	8.6	66.7	66.7	83.3	83.3	60.0
Denver	36.7	6.9	55.2	86.2	55.2	55.2
St. Louis	23.0	11.8	41.2	82.4	64.7	70.6
Seattle	18.4	7.1	28.6	92.9	64.3	7.1
Jacksonville	18.9	50.0	28.6	42.9	35.7	50.0
Combined Total	24.3	44.5	42.1	72.4	53.5	43.2

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

EXHIBIT X-17

FREQUENCY WITH WHICH PARTICULAR PROVIDERS ARE RECOMMENDED TO BUYERS

	PERCENT OF BORROWERS WHOSE LENDERS RECOMMENDED CERTAIN PROVIDERS	PERCENT OF TIME RECOMMENDED PROVIDER WAS THE:				
		ATTORNEY	MORTGAGE INSURER	TITLE INSURER	ESCROW AGENT	SURVEYER
Boston	22.4%	100.0%	31.3%	35.3%	46.7%	56.3%
Los Angeles	29.0	10.0	40.0	70.0	85.0	25.0
San Antonio	20.5	33.5	53.3	80.0	60.0	53.3
Washington, D.C.	17.1	83.3	58.3	58.3	41.7	27.3
Denver	30.4	4.2	54.2	63.3	29.2	29.2
St. Louis	23.0	11.8	52.9	88.2	47.1	35.3
Seattle	30.3	8.7	72.7	87.0	87.0	8.7
Jacksonville	27.0	50.0	65.0	70.0	60.0	47.4
Combined Total	24.4	33.1	54.1	73.0	58.2	33.8

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

When lenders direct home buyers to providers with whom they have a business relationship, they are required to reveal the nature of that relationship. Earlier, it was pointed out that 24.3 percent of the home buyers were required by their lenders to use particular providers. Among this group, 35.4 percent of the buyers were informed that the lender had a particular business relationship with a required provider (see Exhibit X-18). In Boston, a business relationship was acknowledged in nearly 66 percent of the cases where a buyer was required to use a particular provider. As the exhibit shows, those relationships are most often acknowledged to occur with attorneys (71.4 percent of the admitted business relationships). In nearly half of the cases (48.9 percent), business relationships with title insurers were acknowledged.

These figures do not indicate the number of business relationships that are unrepresented by lenders to consumers. They do, however, suggest the frequent incidence of such ties between providers. Another measure of these ties is the extent to which lenders have admitted that particular industry providers may sit on their boards of directors. Lenders were questioned about the frequency that lending institutions of their type had as members of their boards of directors: (1) real estate brokers or agents; (2) home builders; or (3) attorneys whom borrowers were required to use. Relationships seemed to be more frequent among real estate brokers or agents and builders than among attorneys (see Exhibit X-19). Twenty-one percent of the lenders interviewed said they thought over 40 percent of the local lenders had brokers or agents on their boards, 11 percent said that builders were sitting on the boards of more than 40 percent of the local lenders, and only 6 percent said attorneys were represented on the boards of 40 percent or more of the local lenders.

These directorships may represent rather significant conflict of interest situations with certain providers that are required or recommended by lenders. Our interviews did not allow the development of questions that would establish that excessive prices are prevalent in these situations but comments from many sources close to the industry suggest that some damage to the consumer does result from some of these relationships. However, it would be erroneous to conclude that such board relationships are entirely contrary to consumer interests. These builders, brokers, and attorneys can provide valued information in a board member capacity, and it is almost customary within the lending industry to appoint important customers to board positions. In themselves, these relationships do not suggest unacceptable market performance, but they are suggestive of the possibility for consumer abuse if no additional encouragement is given lenders to secure for borrowers an adequate set of services at the least expensive cost, and if consumer information is incomplete or defective.

EXHIBIT X-18

FREQUENCY WITH WHICH A BUYER IS INFORMED OF A LENDER'S BUSINESS RELATIONSHIP WITH A REQUIRED PROVIDER

	COMBINED TOTAL	BOSTON	LOS ANGELES	SAN ANTONIO	D.C.	DENVER	ST. LOUIS	SEATTLE	J'VILLE
Lender Informed Buyer of a Business Relationship With a Required Provider	35.4%	65.8%	–	20.0%	83.3%	24.1%	17.6%	7.1%	42.9%
Required Provider Was An:									
Attorney	71.4	96.0	–	50.0	60.0	33.3	50.0	–	60.0
Escrow Company	30.4	17.4	–	25.0	66.7	42.9	–	100.0	80.0
Title Insurer	48.9	29.2	–	75.0	66.7	85.7	100.0	100.0	20.0

SOURCE: PMM&CO. Home Buyer Survey, 1980.

EXHIBIT X-19

PERCENT OF INTERVIEWED LENDERS DESCRIBING PARTICULAR PROVIDERS AS LOCAL BOARD MEMBERS

PERCENT OF INSTITUTIONS HAVING PROVIDERS ON BOARD	PROVIDERS		
	REAL ESTATE BROKERS OR AGENTS	ATTORNEYS	BUILDERS
0 %	54 %	83 %	60 %
1 - 10 %	18	5	17
11 - 40 %	7	6	12
41 - 90 %	15	4	10
91 - 100 %	6	2	1

SOURCE: PMM&CO. Lender Survey, February 1980.

CONCLUSIONS

Among the five specific settlement service providers that are evaluated in this part of Volume II, the mortgage lenders assume the greatest responsibility in providing a broad range of settlement services. The lender is the most highly regulated; he is given the greatest burden in fulfilling the requirements of RESPA; he is responsible for arranging other necessary settlement services; his prices are most sensitive to continuous changes in financial market conditions; and it is the lender's evaluation which decides if a loan application will go to settlement. Despite this range of responsibilities, the delivery of mortgage financing services is accomplished within an environment that more closely approaches the model of workable competition than any other of the four that we consider.

Due to the lender's diverse responsibilities, the product that he sells is particularly difficult to evaluate. The foregoing analysis indicates that despite available market information, a potentially high heterogeneous product has placed the consumer at a substantial disadvantage. Often the inexperienced home buyer finds access to relevant market information only after he has applied for a loan and after prepayments for particular items dissuade him from capitalizing on his knowledge and shopping further.

The existence of numerous independently acting providers in moderate degrees of price variability in fluid market conditions suggests a relatively high measure of active price competition. A test of overall industry performance, however, is the extent to which the mortgage lending process works at providing to the consumer required services (and not providing a charging for inappropriate or unexcursory services) at near the lowest possible cost. Given the nature of secondary market requirements, some services required by lenders may mistakenly appear unnecessary from the consumer's perspective. Yet some lenders clearly do require services that are redundant or exceed their own and secondary market legitimate needs to ensure the safety and security of mortgage loans. Second, the industry appears to work best by capitalizing upon tied relationships, but overall, the industry does not appear to actively pursue a policy against abuses that can develop out of these relationships.

Finally, the industry has not taken positive steps towards reducing customer confusion and limiting the heterogeneity that characterizes the terms of mortgage financing. Many of the costs associated with real estate settlement are the result of requirements for an efficient secondary market. In spite of these requirements, a more uniform product or one more adaptable to consumer interests could develop if accompanied by effective initiatives.

The overall assessment of market preformance in the mortgage lending industry is fair to good. It appears to deliver a required product efficiently and at reasonable cost. But it follows too rigidly the perceived requirements of the secondary market and is not sufficiently sensitive to the impact pursuing this course has on the cost to the consumer.

XI. PERFORMANCE OF THE PRIVATE MORTGAGE INSURANCE INDUSTRY

Private mortgage insurance is generally required of lenders when the loan-to-value ratio (LTVR) of the mortgage is less than .20. In providing this service, the mortgage insurer agrees to absorb a set portion of the loss that would result from a borrower's defaulting on his mortgage loan. This insurance facilitates high LTVR loans by allowing the lender to transfer to a third party some of the risk inherent in such mortgage lending.

Mortgage insurance is similar to title insurance, in that it does not explicitly benefit the consumer (the home buyer), but is required by the lender. Typically, the mortgage insurer and the home buyer never meet or discuss characteristics of the service, payments options, or its cost.

However, the home buyer almost always directly pays for mortgage insurance. Therefore, there is ambiguity as to who is the buyer or consumer of the service. In the discussion that follows, we refer to the home buyer as the consumer; the lender is sometimes called the buyer.

This chapter indicates the economic performance of the mortgage insurance industry in providing required services at a reasonable cost.[1] We first assess the extent to which the conditions that define pure competition are met. We then use this information, along with data on price variability, industry profitability, reverse competition and other economic characteristics of the industry to determine if active price conpetition, or what we have termed "workable competition," prevails. Finally, we examine other aspects of the provision of mortgage insurance, such as consumer abuse and appropriateness of the product, which are also important in evaluating market performance in this industry.

ASSESSING THE EXTENT OF PURE COMPETITION

Classical economic literature tells us that pure competition results in economic efficiency, so that the consumer is being provided the product or service at the lowest possible cost. While pure or perfect competition is rare and could not be expected in the settlement service industries, it is useful to evaluate the mortgage insurance industry in terms of its four specific conditions of pure competition. The degree to which these conditions are met provides some indication as to whether the market is performing well at providing services efficiently and at a reasonable cost, that is, whether reasonable competition prevails. It also may suggest what characteristics of the market might be changed in order to achieve a higher level of market performance and consumer satisfaction.

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[1] A cost which approximates the lowest possible cost of providing the service.

Condition 1--Product Homogeneity

A homogeneous product allows consumers to make price comparisons among available products more easily and knowledgeably. From the perspective of the home buyer, who in most cases directly pays for mortgage insurance, the insurance is entirely homogeneous except for its pricing characteristics. To the lender, who requires mortgage insurance as a condition of the loan, it can vary in important respects across providers. The basic product of mortgage insurance can best be described as a combination of two distinct components: (1) the transfer of risk from insured to insurer; and (2) a set of additional financial services that are provided primarily to other providers of closing related services (mortgage lenders, escrow agents, and occasionally real estate agents).

The transfer of risk that is created when an insurer accepts a portion of a lender's foreclosure-related losses is nearly identical across mortgage insurers. Generally, lenders require that their mortgagors (home buyers) purchase mortage insurance that provides coverage for 20 percent of the risk of loss for loans which have a loan-to-value ratio of from 80 to 90 percent. For LTVR loans greater than 90 percent, the amount of required insurance coverage is typically 25 percent of the loan amount. Most lenders are not permitted to make conventional loans in excess of a 95 percent LTVR; as a result, no mortgage insurance coverage is available for such LTVR loans.

In recent years, a number of additional policies have been introduced which provide different, and usually lower, levels of coverage. Almost all of these policies are designed to provide lenders with the minimum amount of coverage that will fulfill requirements for sale of the loan to FNMA or to FHLMC, or for the loan's inclusion in conventional mortgage-backed securities. As a result, the mortgage insurance product even lacks product homogeneity from the perspective of the mortgage lender. There is often a "fit" between certain loan characteristics and certain types of coverage, but when the lender is uncertain whether he will hold the loan or to whom he will sell it, the differences in types of insurance coverage become important. Under such conditions, the lender typically requires that the most conservative level of coverage be purchased.

In addition to different types of coverage, there is another, more subtle distinction to the transfer-of-risk component of the mortgage insurance product. That distinction involves the lender's perception of the underlying ability of the particular mortgage insurer to make subsequent payments for claims as they are filed. In Chapter IV we indicated that each mortgage insurer must maintain a 25:1 risk-to-capital ratio, and must also maintain other indicators of financial and operating performance deemed necessary both for: (1) licensing by the insurance commission in the state in which it is domiciled, and (2) approval by FNMA and FHLMC for insurance of loans that they might purchase. These performance requirements, however, represent merely a minimum set or "floor" of financial requirements for the industry.

Beyond these, lenders look closely at the financial resources of the mortgage insurers to assure that adequate levels of protection will be available in the event of a substantial economic downturn accompanied by a high rate of foreclosure-induced claims. Those firms that have been in business longest, are most geographically diversified, and have had the opportunity to build up their reserves, are often perceived to be significantly more desirable than newer firms with fewer assets and a more concentrated insurance portfolio. As a result, the balance sheet of a mortgage insurer, and a lender's interpretations of his financial integrity and ability to withstand loss, all contribute to substantially differentiating mortgage insurance providers.

Chapter IV goes into some detail in describing the alternative forms of coverage or forms that the mortgage insurance product may take. That chapter also describes the second component of the insurance product--a range of ancillary services and products made available to lenders by almost all insurers. It is primarily through these additional services that insurers compete with one another for a lender's business. As Chapter IV indicates, these services include but are not limited to: (1) third-party review; (2) prompt and personal service; (3) sales and marketing support; and (4) secondary market assistance.

Across this wide range of services, two particular activities stand out as very important in maintaining satisfied lender customers. In our survey of lenders, more than 25 percent of the 18 percent of all lenders who had dropped an insurer from use during the preceding three years did so because of inadequate or slow service in processing claims. This is a necessary and basic component of the insurance process, but the ability of the insurer to confidently and efficiently settle claims may substantially differentiate him and his product from that of the competition.

The second most critical service takes the form of secondary market assistance. Mortgage insurers are able to provide a contact or brokerage function to their lenders by bringing together investors (primarily S&Ls but also insurance companies and some pension funds) with primary lenders who are able to originate more loans than they choose to hold in their own portfolios. The mortgage insurer provides this service at no explicit charge and can do so efficiently because of his continuous contact with financial market participants and his familiarity with their investment and placement requirements.

Secondary market assistance was clearly considered by the insurers interviewed as the most important service they can offer to develop additional business. The full range of services, however, is important to lenders, and each of the large mortgage insurers (roughly those within the top two tiers of the three-tier industry) have an advantage in being able to allocate the resources necessary to better fulfill lender requirements.

While product homogeneity exists somewhat in terms of definition of risk that is transferred from lender to insurer, it is significantly blurred when evaluating the financial integrity of the firm and the range and quality of services that it makes available. These factors, however, differentiate mortgage insurers from the perspective of the mortgage lender only. From the vantage of the home buyer, who almost always directly pays the cost of mortgage insurance, these additional services provide little direct benefit. As a result, home buyers view mortgage insurers as nearly an entirely homogeneous group, each of whom is able to provide the necessary requirement that will allow the consumer to qualify for a high LTVR loan. Differentiation by consumers that does occur is based primarily upon pricing factors or, more specifically, upon the terms by which mortgage insurance is paid.

Condition 2--Numerous Independent Buyers and Sellers

A highly competitive environment surrounding the purchase and sale of mortgage insurance requires that no single (or small group of) buyer or seller is able to influence market behavior. That is, the output of each is so small relative to the size of the market that its actions to expand or contract quantities supplied will have no perceptible impact on the market price. Evidence presented in Chapter IV suggests that the competitive marketplace for lenders and insurers is substantially impaired by the industry structure. One firm (MGIC) accounted for more than 40 percent of new premiums written in 1979, and it accounts for even a larger amount of total outstanding insurance. A second tier of six firms accounted for an additional 53 percent of premiums written in 1979.

This structure suggests that a significant amount of market control or influence remains in the hands of a small number of insurers. Because there are only 14 active sellers (or insurers), several of whom are active in only a small number of states, it is easy for the industry to watch the actions of individual firms and to emulate them when they appear attractive. Industry behavior has very closely followed this practice in developing new products, pricing mechanisms, and services.

However, the structure of the industry in terms of market dominance or market share has shifted somewhat during the past three years and may vary substantially by market area. Market independence is viewed from three distinct perspectives:

- market concentration and trends in national market share;
- market share within the ten states (eight sites) in which we have conducted our interviews;
- market influences in the form of relationships that develop within the industry which impact consumer interests relating to the mortgage insurance product.

Each of these perspectives is discussed below.

National Market Share

Although MGIC is by far the leader of the mortgage insurance industry, that firm is slowly forfeiting market share to its smaller and possibly more aggressive rivals. Significant inroads were made into MGIC's national market share during the early 1970s, and from 1970 to 1976, MGIC's share of new premiums written declined from 65.2 percent of the industry total to 46.9 percent. The rate at which MGIC has given up market share, however, has slowed significantly since then. Exhibit XI-1, which appears earlier in Chapter IV, is repeated in this discussion. It shows that the market share of MGIC--the first tier firm--declined to 40.6 percent during 1979. MGIC's annual premiums written during that period (1976-1979) grew at an annual rate of 14.9 percent but did not keep up with the industry's sustained annual growth rate of 20.6 percent.

As Chapter IV indicates, the second tier firms were primarily the beneficiaries of MGIC's loss in market share. The combined market share of these six firms increased from 34.8 percent in 1970 to 53.6 percent in 1979. The seven firms representing the third tier of the industry captured the national market share lost by both other tiers. Between 1973 and 1979, their combined market share increased from less than one percent to 5.8 percent.

Exhibit XI-2 presents in greater detail national market share figures for each of the 14 mortgage insurance firms from 1976 to 1979. Although only 0.8 percent of new market share has been given up during 1979 by firms in the top two tiers to those representing the third tier, a very interesting shift in market position has occurred within the second tier. United's portion of new market share has declined each year from 1976 through 1979, and it has given up second place in the industry to VEREX. During that four-year period, TICOR has moved up from sixth to fourth place within the industry, and in 1979 was only 0.1 percent from United's market share. PMI has similarly moved up from seventh to fourth place within the industry, at the expense of both AMI and Tiger, who have forfeited some of their market share each year since 1976.

Collusive or noncompetitive pricing tends to be most common within industries that are highly concentrated, and the mortgage insurance industry has demonstrated consistently high, although slightly declining, concentration ratios since its beginning in 1957 when the industry was one firm, MGIC. Exhibit XI-3 shows four- and eight-firm national concentration ratios for each of the years 1976 to 1979. During that period, the four-firm ratio declined from 78.8 to 72.8 percent, and the eight-firm ratio was reduced from 98.5 to 96.6 percent.

At the national level, these data indicate three specific trends. First, the industry has maintained a significantly high level of concentration. Although MGIC is less the market force than it was as recently as the mid-1970s, the firm continues to dominate the market by its established name (which in some areas is a generic reference to mortgage insurance) and its accumulated capital. Second, the gradual but slight decline in concentration ratios suggests that although firms are jockeying for positions, each of the second tier

EXHIBIT XI-1

NATIONAL MARKET SHARE BY TIER GROUP IN TERMS OF DIRECT PREMIUMS WRITTEN, 1970 - 1979

	YEAR					
	1970	1973	1976	1977	1978	1979
Tier 1	65.2%	60.8%	46.9%	43.1%	41.1%	40.6%
Tier 2	34.8	38.5	49.6	52.3	53.9	53.6
Tier 3	–	.7	3.4	4.5	5.0	5.8
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Size of Market	$ 21,425	$164,317	$181,306	$234,222	$297,503	$318,041

(Industry Total Direct Premiums
Written – ooo's)

SOURCE: NAIC Statutory Statements (1970 - 1979).

EXHIBIT XI-2

NATIONAL MARKET SHARE IN TERMS OF DIRECT MORTGAGE INSURANCE PREMIUMS WRITTEN, 1976 - 1979.

Percentage

	1976	1977	1978	1979
FIRST TIER:				
MGIC	46.9	43.1	41.1	40.6
SECOND TIER:				
UNITED	12.1	12.0	11.5	10.3
VEREX	12.0	12.1	11.7	11.7
TICOR	6.3	8.2	9.7	10.2
PMI	4.7	6.1	7.2	8.0
AMI	7.8	7.5	7.4	7.1
TIGER	6.7	6.4	6.4	6.3
(SECOND TIER TOTAL)	(49.6)	(52.3)	(53.9)	(53.6)
THIRD TIER:				
REPUBLIC	2.0	2.1	2.3	2.4
FOREMOST	0.9	1.3	1.5	1.5
HOME	0.1	0.5	0.5	0.5
COMMERCIAL	0.1	0.3	0.4	0.4
PAMICO	0.2	0.2	0.2	0.3
COMMONWEALTH	–	–	0.1	0.5
INTEGON	0.1	0.2	0.1	0.2
(THIRD TIER TOTAL)	(3.4)	(4.5)	(5.0)	(5.8)
	100.0	100.0	100.0	100.0

SOURCE: NAIC Statutory Statement, 1976 – 1979.

EXHIBIT XI-3

NATIONAL MARKET SHARE CONCENTRATION IN TERMS OF PREMIUMS WRITTEN, 1976 - 1979

CONCENTRATION RATIO	1976	1977	1978	1979
Top 4 Firms	78.8%	75.4%	74.0%	72.8%
Top 8 Firms	98.5%	97.5%	97.3%	96.6%

SOURCE: 1976 - 1979 Annual Statements filed with State Insurance Commissioners.

firms is somewhat firmly entrenched there. The largest increases in market share during 1979 were achieved by PMI (which increased its share by 0.8 percent), by TICOR (0.5 percent) and by Commonwealth (0.4 percent). PMI and TICOR, however, capitalized upon their presence in the strong California market and increased their penetration into local market areas throughout much of the country.

The third trend relates to the possibly limited market potential of the third tier firms. In the third tier no firm other than Commonwealth increased its market share significantly. Four are now established firms (having been organized in 1972), and with the exception of Republic and Foremost, none has been too successful at expanding its market penetration outside of the local market in which it is domiciled. The founders or principals of these firms tend to be acquainted with executives of local and regional lending institutions, which enables them to develop local markets. Expansion beyond these local or regional levels, however, has been difficult for most of these third tier firms because of their relative disadvantage in competing with the larger firms of the first two tiers.

Regional Market Share

First and second tier firms are licensed in all ten of the states in which we have conducted our on-site interviews. As expected, however, there is significant fall-out among the third tier firms with regard to being licensed in some of the states (Exhibit XI-4). Home is licensed in only four of the ten states, Republic and Integon in six. While Pamico was licensed in seven of the ten states in 1979, it remains the most geographically concentrated in terms of business activity of the 14 insurers. In that year, direct premiums written in its home state of Pennsylvania accounted for more than 90 percent of total premiums written.

Among the ten states, California, Massachusetts, and Washington have only nine licensed insurers; Virginia, the District of Columbia, and Florida and the only areas in which all 14 firms are licensed. All other states have 11 to 13 licensed insurers.

Concentration ratios for some of the states studied are substantially different than national concentration ratios. Exhibit XI-5 presents concentration ratios of the top four and eight firms for each of the ten states for 1976 and 1979. Concentration is again expressed in terms of annual premiums written in each of the states. Massachusetts was the most concentrated of the ten states; in 1979, 92.3 percent of the state's total mortgage insurance premiums was written by only four firms, and eight firms accounted for all of the premiums. This has happened principally because smaller and newer firms are reluctant to commit the resources necessary to develop business in a state that does not promise significant growth.

Other states, however, such as Virginia, Maryland, Florida, and to some extent California and Washington, offer greater market potential. These states have lower concentration ratios because they have a high rate of sustained

EXHIBIT XI-4

LICENSED AND ACTIVE MORTGAGE INSURERS
10 SELECTED STATES
1979

FIRM	CALIF.	COLO.	D.C.	FLA.	MD.	MASS.	MISSOURI	TEXAS	VIRGINIA	WASH.	NUMBER OF TEN STATES IN WHICH	
											LICENSED	ACTIVE
MGIC	●	●	●	●	●	●	●	●	●	●	10	10
UNITED	●	●	●	●	●	●	●	●	●	●	10	10
VEREX	●	●	●	●	●	●	●	●	●	●	10	10
TICOR	●	●	●	●	●	●	●	●	●	●	10	10
AMI	○	●	●	●	●	●	●	○	●	●	10	8
PMI	●	●	●	●	●	●	●	●	●	●	10	10
TIGER	●	●	●	●	●	●	●	●	●	●	10	10
REPUBLIC			●	●	●		●	●	●		6	6
FOREMOST	○	●	○	●	○		○	●	●	●	9	5
HOME			●	○	●				●		4	3
COMMERCIAL	●	●	●	●	●	●	○	●	●		8	7
PAMICO		○	○	○	●			○	●	○	7	2
COMMONWEALTH	●	●	○	○	●	○		●	●		8	5
INTEGON		●	○	●			●	●	●		6	5
Number of Licensed Insurers:	9	12	14	14	13	9	11	13	14	9		
Number of Active Insurers:	7	11	10	11	12	8	9	11	14	8		

○ : Licensed
● : Active

SOURCE: 1979 Statutory Statements.

EXHIBIT XI-5

CONCENTRATION OF TOP FIRMS IN TERMS OF ANNUAL PREMIUMS WRITTEN IN TEN STATES, 1976 & 1979

Percentage

STATE	TOP 4 FIRMS		TOP 8 FIRMS	
	1976	1979	1976	1979
California	78.4	71.5	100.0	99.8
Colorado	86.8	82.9	100.0	99.6
District of Columbia	92.6	85.2	100.0	99.8
Florida	79.6	67.3	99.7	98.4
Maryland	67.2	68.3	98.3	93.5
Massachusetts	99.5	92.3	100.0	100.0
Missouri	95.0	88.4	99.9	100.0
Texas	87.4	81.5	99.8	97.5
Virginia	73.6	64.3	97.3	92.9
Washington	75.6	70.4	100.0	99.9
United States	78.8	72.8	98.5	96.6

SOURCE: NAIC Statutory Statements.

growth and (with the exception of the two firms domiciled in California) provide no insurer with a domiciled advantage. For purposes of reference, Exhi-XI-6 illustrates each firm's state market share in terms of direct premiums written for the years 1976 through 1979.

Other Elements of Market Influence

In evaluating market influence we have considered the extent to which exclusive or near exclusive relationships develop between lenders and mortgage insurers. To the extent that no insurer relies heavily upon the business provided by a small group of lenders, or that no single lender uses only one or two mortgage insurers, both buyers and sellers are acting in a relatively independent and uninfluenced fashion.

Geographic diversity and a willingness to do business with a large number of different lenders reduces the risk for insurers in the event of natural catastrophes or severe regional recessions caused by heavy dependence upon particular manufacturing sectors. As Chapter IV indicates, most insurers issue master policies to lenders as part of an agreement stating that they will insure loans that the lender has originated. None of the insurers we interviewed indicated that they had master policies in force with fewer than 650 lenders; some insurers had in excess of 6,000 master policy holders, and the average for all insurers interviewed was about 2,900.

A further test of diversification by insurers is the extent to which a single customer (or lender) accounts for a large proportion of the insurer's business. Twelve of the 14 firms indicated that no single lender accounted for more than 4 percent of its new insurance written during 1978. For many of these firms, particularly those among the top two tiers of the industry, no single lender accounted for more than one or two percent of its 1978 business. One insurer, however, admitted that a single lender accounted for as much as 15 percent of its business. These responses strongly suggest that no single lender is in a strong position to influence the insurer, because very few lenders across the country represent a major customer to any insurer.

We also asked insurers the extent to which they were able to influence lenders to establish near exclusive relationships with them, that is, a situation in which more than 60 percent of a lender's business would go to a single insurer. Although developing such relationships is desirable from the perspective of the insurer, nearly all indicated that the competitive nature of the market-place made this very difficult. Only one insurer received 60 percent or more of its business from 10 to 25 percent of its customers. All 13 other insurers received 60 percent or more of the insurance business from less than 10 percent of their customers.

These results were supported by our interviews with mortgage lenders, who indicated that, on average, they had master policies with 5.6 mortgage insurers; only 19.7 percent of the total respondents used only three or fewer mortgage insurers. Exhibit XI-7 (which is reprinted from Chapter IV) indicates that the group using only one to three mortgage insurers is principally made

EXHIBIT XI-6

MARKET SHARE OF PRIVATE MORTGAGE INSURANCE DIRECT PREMIUMS WRITTEN
1976 - 1979

%

	CALIFORNIA	COLORADO	DISTRICT OF COLUMBIA	FLORIDA	MARYLAND	MASSACHUSETTS	MISSOURI	TEXAS	VIRGINIA	WASHINGTON	UNITED STATES
MGIC	36.1 31.3 29.2 27.7	50.6 40.2 34.9 35.7	49.9 52.1 50.4 48.8	38.0 34.2 33.1 33.8	30.8 30.1 33.0 31.7	56.2 50.4 49.3 47.5	54.5 47.0 47.1 44.8	52.7 45.7 38.6 37.9	37.9 30.8 30.7 30.2	27.3 29.7 25.8 21.4	46.9 43.1 41.1 40.6
UNITED	8.8 7.9 9.6 8.5	9.0 7.3 6.0 6.4	2.6 2.5 2.6 2.9	16.4 14.3 12.1 8.4	11.0 8.7 9.0 8.5	7.3 9.2 10.1 7.1	14.7 15.6 17.2 13.3	6.5 7.3 5.8 6.3	15.2 14.2 15.2 11.2	25.7 23.3 21.9 18.4	12.1 13.0 11.5 10.3
VEREX	6.7 8.2 10.4 10.7	6.5 6.8 7.7 7.1	16.6 14.2 10.8 8.8	14.9 15.7 15.4 14.9	12.7 16.7 10.5 11.3	9.8 7.9 8.6 8.2	13.0 14.6 14.3 16.8	12.1 10.5 9.2 8.3	10.3 7.1 6.0 7.4	7.2 9.4 10.0 10.3	12.8 12.1 11.7 11.7
TICOR	21.2 18.9 18.4 17.2	9.3 16.4 17.8 18.3	2.8 3.7 4.4 6.6	4.5 5.3 7.2 9.0	12.7 13.8 13.4 13.8	— — — —	— 2.5 3.6 5.5	12.9 16.7 20.7 21.8	7.6 9.5 8.4 11.0	10.2 10.8 11.2 9.7	8.3 8.2 9.7 10.2
PMI	11.7 14.3 13.3 14.8	5.9 10.3 13.4 15.0	6.4 10.3 13.5 16.7	3.7 5.5 6.6 7.9	7.9 8.1 11.4 11.5	.5 4.4 8.4 12.4	2.5 3.7 3.8 3.2	9.7 13.6 14.2 14.3	10.2 9.7 10.4 10.2	11.9 13.8 14.9 16.8	4.7 6.1 7.2 8.0
AMI	6.8 6.2 7.1 7.7	.8 .9 2.8 2.9	2.1 1.4 1.6 1.3	8.0 8.3 9.6 9.6	7.4 5.2 4.8 4.2	— — — .1	11.9 13.3 11.0 10.7	— — 2.0 2.1	7.8 6.6 5.3 5.3	7.0 6.7 8.3 8.9	7.8 7.5 7.4 7.1
TMIC	11.4 12.2 11.2 11.7	17.9 19.0 17.1 13.8	18.7 14.3 13.0 10.9	10.3 8.5 7.0 6.6	10.9 7.4 6.9 5.8	29.2 28.1 25.4 24.2	1.9 2.7 3.0 2.7	3.7 3.3 3.2 3.4	2.9 3.8 3.5 3.3	10.7 11.2 13.3 13.8	6.7 6.4 6.4 6.3
REPUBLIC	— — — —	— — — —	— .8 2.3 2.2	3.9 7.1 8.0 8.1	5.5 6.9 5.7 6.1	— — — —	— — — —	— — 2.1 3.8	5.4 5.8 6.1 5.7	— — — —	2.8 2.1 2.3 2.4
FOREMOST	— — — —	— .1 .1 —	— — — —	.3 .7 1.0 1.1	— — — —	— — — —	— — — —	2.3 3.8 3.1 2.5	.2 .1 .1 .1	— — — .7	.9 1.3 1.5 1.4
HOME	— — — —	— — — —	— .4 .5 1.4	— — — —	— .9 1.5 1.6	— — — —	— — — —	— — — —	2.4 13.0 12.1 11.9	— — — —	.1 .5 .5 .5
COMMERCIAL	— — — —	— — .2 .3	— .2 .7 .6	— .3 .6 .5	1.7 3.7 5.2 4.7	— — — .5	— — — —	— — .1 .1	.1 .9 2.2 3.0	— — — —	.1 .3 .4 .4
INTEGON	— — — —	— — — —	— — — —	— — — .1	— — — —	— — — —	.6 .5 .3 .2	.1 — — .1	— — — .2	— — — —	.1 .2 .1 .2
PAMICO	— — — 1.5	— — — —	— — .2 —	— — — —	— — — .2	— — — —	— — — —	— — — —	— — — .3	— — — —	.2 .2 .2 .3
COMMONWEALTH	— — — 1.5	— — — .3	— — — —	— — — —	— — — .5	— — — —	— — — —	— — — .2	— — — .2	— — — —	— — .1 .5

KEY

FIRM	MARKET
	1976 1977 1978 1979

SOURCE: [illegible]

EXHIBIT XI-7

DISTRIBUTION OF INSTITUTIONS HAVING MASTER POLICIES WITH DIFFERENT MORTGAGE INSURERS

PERCENTAGE

NUMBER OF MASTER POLICIES	COMMERCIAL BANKS	SAVINGS & LOANS	MUTUAL SAVINGS BANKS	MORTGAGE BANKS	TOTAL
1-3	38.0	18.0	37.5	12.5	19.7
4-6	62.0	44.2	50.0	54.2	49.0
7-10	12.0	31.6	12.5	27.8	26.5
more than 10	0.0	6.2	0	5.5	4.8
Total	100.0	100.0	100.0	100.0	100.0

NUMBER OF MASTER POLICIES	BOSTON	WASHINGTON, D.C.	JACKSONVILLE	SAN ANTONIO	ST. LOUIS	DENVER	LOS ANGELES	SEATTLE	TOTAL
1-3	42.8	15.2	20.0	33.3	31.6	12.1	10.0	7.4	19.7
4-6	52.4	33.3	45.0	50.0	26.3	60.6	63.3	51.9	49.0
7-10	4.8	36.4	30.0	12.5	42.1	24.3	23.3	37.0	26.5
more than 10	0	15.1	5.0	4.2	0.0	3.0	3.4	3.7	4.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: PMM&CO. Lender Survey, February 1980.

up of commercial banks and savings banks. Among the more active mortgage lenders, 82 percent of the S&Ls reported using four or more insurers, as did nearly 88 percent of the mortgage bankers.

Summary

The structure of the mortgage insurance industry suggests that concentration is shifting from MGIC and towards those firms that make up the second tier. However, new market entrants are unlikely, and there will remain a high degree of concentration by a small group of firms and great market influence by a single firm. This could undermine levels of both price competition and efficiency within the market.

Our discussions with individual buyers and sellers, however, indicate a strong element of independence and a surprising absence of market control. There appear to be very few exclusive relationships formed, or at least admitted to by buyers and sellers. Although some insurers have been able to offer incentives (in terms of better service) to increase the number and degree of near exclusive relationships, they appear to have been relatively unsuccessful. Lenders feel it is prudent to diversify their loan portfolio with regard to mortgage insurers. They have also indicated that they can often secure better service and attention from mortgage insurers when they are in a position to play one against the other for larger portions of a single lender's insurance needs. This suggests that there is a strong incentive to perform and to keep the lender satisfied. It does not, however, suggest that active price competition exists for mortgage insurance.

Condition 3--Market Information

A perfectly competitive market requires both buyers and sellers to have perfect information relating to price and to product characteristics. In discussing market information it is important to distinguish between information available to the lenders, who require mortgage insurance, and the home buyers, who pay for it. Information regarding prices, payment plans, and product characteristics available only to the lender may be of little value to the home buyer if the lender chooses the provider and the payment plan and is responding primarily to his own interests in doing so.

A significant amount of market information is available to the mortgage insurer from two distinct sources. Nearly all changes in price and structure of an insurance policy must be filed with a state's Office of the Insurance Commissioner. Often this information is publicly accessible, and therefore almost all insurers can follow product changes initiated by other firms within the industry. At the practical level, however, a continuous dialogue usually goes on between the marketing representatives of the insurer and the mortgage lender. Through these conversations, insurers are kept aware of actions taken by other insurers, and by so doing, lenders are often able to solicit better service from all insurers.

This behavior suggests that a very high level of market information is available to both buyers (lenders) and sellers, and that it is productively channeled in the direction of both a more efficient and a more competitive marketplace. However, an adequate level of market information also suggests that no buyer or seller is injured by an absence of such information; to the extent such injury occurs, market flaws may exist.

The relationship between consumer and mortgage insurer has been described as a classic example of reverse competition. (This is discussed more thoroughly later in this chapter). In fact, direct contact between consumer and insurer rarely occurs. Ten of the insurers indicated that it never happens; the other four firms indicated tha it happens far less than one percent of the time, and many of these contacts are reportedly initiated by loan applicants who have been rejected by a lender claiming a lack of insurance approval as the reason for rejecting the application.

Despite the influence reverse competition has upon this relationship, the consumer remains in a vulnerable position for lack of information concerning the mortgage insurance product. Mortgage insurers were asked whether they played a role in educating the borrower about the purpose of private mortgage insurance. Half of the insurers responded that they did by providing literature that lenders can distribute to loan applicants, and by providing lectures to both lenders and real estate agents concerning the mortgage insurance that can be used in qualifying borrowers for loans. In both these situations, however, the focus is on the use of mortgage insurance and not upon consumer-related issues such as price, type of coverage, or cancellation requirements. An evaluation of consumer attitudes and experiences is a better index of the extent to which a lack of information regarding mortgage insurance has been damaging.

Consumer Awareness

In our survey of home buyers in the eight SMSAs, 208 of 599 respondents acknowledged that they had purchased private mortgage insurance (some of the 638 interviewees did not know or did not remember). This represents 34.7 percent of the interview sample and suggests that a high proportion of home buyers are assisted in their home purchase by private mortgage insurance coverage. The distribution in sampled buyers who used mortgage insurance varied substantially. In Boston, about one out of four buyers purchased mortgage insurance; in Denver, nearly one out of two buyers did (see Exhibit XI-8, which also appears in Chapter X).

The market information that is available to consumers is very important in assessing the level of competition that accompanies the sale of the mortgage insurance product. Responses to our questionnaires suggest that the consumer is relatively uninformed about alternatives. Earlier we have indicated that both the real estate agent and the lender play an important role in influencing the selection of the mortgage insurer. However, because the consumer lacks alternative sources of information, both these groups share a responsibility in providing the consumer with adequate information concerning mortgage insurance.

EXHIBIT XI-8

PERCENT OF ALL CONSUMER RESPONDENTS WHO ATTRIBUTED AN INFLUENCE IN THE SELECTION OF THE MORTGAGE INSURER, SELECTED SMSAs; 1979 - 1980.

	INITIAL BUYER SURVEY	BUYER TELEPHONE SURVEY
Agent Required a Particular Insurer	3.9%	2.2%
Agent Recommended a Particular Mortgage Insurer	21.3	24.6
Agent Influenced Decision to Select a Mortgage Insurer	25.2%	26.8%
Lender Required a Particular Mortgage Insurer	10.1%	3.9%
Lender Recommended a Particular Mortgage Insurer	13.0	14.7
Lender Influenced Decision to Select a Mortgage Insurer	23.1%	18.7%

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

Exhibit XI-8 also indicates that only about 55.2 percent of the home buyers requiring mortgage insurance had someone discuss the product with them. Of that group, 89.6 percent discussed elements of price; 52.4 percent discussed policy differences; and only 39.2 percent had someone discuss policy cancellations with them. (Because the lender is responsible for the decision regarding policy cancellation, that subject is considered in Chapter X). In that all of these elements of the mortgage purchase decision are important, it appears that the consumer is frequently left out of relevant discussions regarding contractual relationships with the lender and the mortgage insurer.

During our interview process, lenders were asked how frequently they discuss alternative mortgage payment plans with the borrower. Exhibit XI-9 shows that such alternatives are not discussed with borrowers nearly 65 percent of the time (although the Washington, D.C. area was by far the exception, with only 19 percent of the lenders admitting to no discussions of alternative insurance plans), and that mortgage bankers are the lenders most inclined to have such discussions with consumers. The figures in this table suggest that lenders do not assume full responsibility for discussions with borrowers.

The consumers who discussed mortgage insurance alternatives indicated that the lender provides that discussion in only about 37.3 percent of the cases. The real estate agent was named nearly as frequently (36.4 percent), and both the attorney and the title insurance representative also provide such market information. As Exhibit XI-10 illustrates, the role played by any particular provider in discussing mortgage insurance with the borrower differs substantially by geographic market area.

Consumer interviews illustrate a situation in which a lack of market information may result in some injury or economic loss to the consumer. Of the respondents who purchased mortgage insurance, 36.5 percent said they were unaware that an increase in their down payment could result in a reduction in their contract mortgage rate, in their mortgage insurance premium, or both. This suggests that in more than one out of three situations, these home buyers were presented with inadequate information concerning the mortgage insurance product. However, of the group that was aware that a larger down payment could result in lower mortgage insurance premiums or in a lower mortgage rate, only one in five indicated that such knowledge influenced the amount of their down payment.

Summary

Our findings suggest that both lenders and insurers have a high degree of market information and are able to act upon that information to add both efficiency and productive rivalry to the marketplace. In many situations, however, the consumer is left out of that flow of relevant information. Particularly noteworthy is that two-thirds of the time, lenders do not inform home buyers of the different price and payment options available. It appears that no specific party is given responsibility for explaining or discussing the purchase of mortgage insurance with the borrower; many different providers may fulfill this role, but responses suggest that in nearly half the instances, the consumer has been left substantially uninformed.

EXHIBIT XI-9

PERCENT OF LENDERS WHO INDICATED THEY DO NOT DISCUSS ALTERNATIVE MORTGAGE INSURANCE PAYMENT PLANS WITH THE BORROWER (SELECTED SMSAs: 1979 - 1980)

Percentage

COMBINED TOTAL	BOSTON	DENVER	W.D.C.	J'VILLE	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE
64.6	81.0	47.1	19.0	64.3	58.8	82.4	69.0	85.7

COMBINED TOTAL	COMMERCIAL BANKS	S&Ls	MSBs	MORTGAGE BANKS
64.6	80.0	71.6	86.7	46.8

SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT XI-10

TYPE OF PROVIDER WITH WHOM BORROWER DISCUSSED PRIVATE MORTGAGE INSURANCE (SELECTED SMSAs: 1979 - 1980)

Percentage

PROVIDER	COMBINED TOTAL	BOSTON	LOS ANGELES	SAN ANTONIO	D.C.	DENVER	ST. LOUIS	SEATTLE	J'VILLE
Real Estate Agent	36.4	–	80.0	45.5	21.1	66.7	36.8	7.7	61.5
Attorney	15.5	54.5		9.1	42.1		5.3		
Lender	37.3	18.2		36.4	36.8	40.0	57.9	61.5	7.7
Title Insurance Representative	9.1	18.2		27.3		13.3	15.8	7.7	15.4
Other	18.2	9.1	40.0		5.3	20.0	5.3	23.1	30.8

NOTE: Percentages may add to more than 100 percent if more than one party discussed mortgage insurance with the borrower.

Condition 4--Absence of Entry Barriers

A fourth requirement of pure competition prohibits substantial barriers to entry into the industry by interested firms. Such barriers would restrict the potential number of insurers and thereby could reduce the level of competition within the industry. The reduction in the number of insurers could also result in higher prices and could result in less than optimal output.

The mortgage insurance industry is, in part, a product of the regulatory environment. The industry is regulated directly at the state level, and somewhat indirectly at the federal level through requirements mandated by FNMA and FHLMC for approval as acceptable insurers of loans that they purchase. These requirements are addressed in greater detail in Chapter IV. Requirements at the state level vary significantly with regard to the initial capital requirement necessary for licensing. As Exhibit XI-11 illustrates, this amount may range from $250,000 (as in Maryland) to $2 million. These amounts, however, are small in comparison to the $5 million in capital and surplus required for approval by FNMA and FHLMC.

Some economists would argue that capital requirements are not a true barrier to entry, as potential entrants could attract capital from invenstors if the projected return was sufficiently high. This argument, however, may not always be valid where small independent companies are the potential market entrants. In the case of Mid-Atlantic Mortgage Insurance, Inc., a potential new entrant to the industry sued FHLMC on the grounds that its $5 million capital requirement was unreasonable. The suit was dismissed; the capitalization requirement was found to be reasonable, and Mid-Atlantic backed out of its attempt to enter the mortgage insurance industry.

No mortgage insurer has entered the industry since Commonwealth Mortgage Assurance, Inc., was incorporated in 1976. This suggests that substantial barriers exist in preventing new entrants, and in fact, two very important characteristics of the industry cause this to be true: (1) the practice of recognizing earned premiums that is required in every state; and (2) the tremendous importance establishment and name recognition play in marketing within the industry.

Each state has adopted the requirement of a contingency reserve as set forth in Section 5.12 of the NAIC Model Act (see Appendix E). Accordingly, one-half of all premiums earned are to be set aside for a period of not less than 120 months unless losses are greater than 35 percent of premiums earned, in which case reserves may be released to pay these losses. Such a reserve requires that firms be able to cover their normal business expenses out of the nonreserve portion of their premiums written, or out of additional capital or surplus.

This requirement places severe limitations on a younger firm's ability to enter the industry, incur the large start-up expenses natural to any business initiation, and avoid cash flow problems. As a result nearly all of the 14

EXHIBIT XI-11

CAPITAL AND RATE CHANGE REQUIREMENTS OF SELECTED STATE INSURANCE COMMISSIONS

STATE	MECHANISM FOR RATE CHANGE	MINIMUM PAID IN CAPITAL & SURPLUS
California	Open Competition	$2.0 Million
Colorado	Open Competition	275,000
District of Columbia	File and Use	600,000
Florida	File and Use	$1.75 Million
Maryland	File and Obtain Approval to Change	250,000
Massachusetts	File and Use	600,000
Missouri	File and Use	800,000
Texas	Rates Fixed by State	300,000
Virginia	File and Use	$2.0 Million
Washington	File and Use	$2.0 Million

SOURCE: PMM&Co. insurance commissioner interviews, 1979 – 1980.

mortgage insurers are a part of a broader holding company structure. A successful, growing mortgage insurer requires substantial long-term capital to enter the industry and remain solvent until the 10-year contingency reserves required by state law become accessible. In addition, the 25:1 risk: capital ratio imposed on the insurers by FNMA/FHLMC regulations may prohibit new entrants from increasing insurance in force as rapidly as would be possible without adherence to the ratio. Some third tier firms have indicated that a lack of capital or a lack of financial commitment by a parent company has prevented them from pursuing greater geographic expansion.

The need for a long-term capital commitment in entering the mortgage insurance industry is made greater by the difficulty faced by younger firms in penetrating some market areas. The relatively limited success of some of the third tier firms--each of whom entered the industry between 1972 and 1976--illustrates the problems facing new entrants. Name recognition, demonstrated performance, and adequate capital reserves all influence the process of selecting a mortgage insurer, and an absence of these characteristics has effectively limited all third tier firms from expanding much upon their local or regional market.

In theory, there are no insurmountable barriers to the mortgage insurance industry, but in practice the structure and recent performance of all firms do not suggest a high probability of success for new entrants. It is uncertain, given the reverse competition character of the market, whether the existing barriers to entry contribute to a reduction of overall efficiency and market competition. However, the firms that appear to be the most active price competitors are among the newest and smallest firms in the industry.

CRITERIA FOR EVALUATING WORKABLE COMPETITION

Pure competition is a relatively abstract concept and not likely to be achieved in the market for mortgage insurance. The conditions of pure competition, however, establish the background for an evaluation of market performance in terms of the extent to which an adequate level of workable competition exists. In a marketplace characterized by workable competition, active price competition compels providers to supply the product to the consumer at the lowest possible price. This section considers three distinct elements in evaluating the extent to which the market for mortgage insurance is characterized by workable competition. These include: (1) price variability; (2) the conditions of reverse competition; and (3) reasonableness of profit.

Price Variability

Evidence of price variability is important to this discussion because it provides some indication of workable or active price competition. The implications of the absence of price variability, however, are not as easy to identify. Price stability or even price uniformity may be an indication of near perfect competition, but at the same time, they may suggest implicit or explicit collusion or the actions of a recognized and accepted market leader. The background and development of the mortgage insurance industry play an important role in understanding current pricing practices.

Historical Perspective

Historically, the mortgage insurance industry has demonstrated almost no price variation and there is a well established tradition of closely maintained price stability. Chapter IV describes the development of the initial rate structure for the industry as a reduced variation of the FHA pricing structure. The early FHA single family insurance program was able to develop large reserves with annual premiums of 0.50 percent of the outstanding mortgage balance. Founders of MGIC argued that a conventional insurance program, using tighter underwriting procedures and a more limited guarantee provision, would be able to operate as successfully.

In 1957 the cost of the initial conventional mortgage insurance providing 20 percent coverage for a 90 percent LTVR loan was 0.50 percent in the first year, with reduced renewal premiums of 0.25 percent in subsequent years. A single premium plan was available providing similar coverage for a single front-end charge of 2 percent of the loan amount.

During the next two decades, industry growth was rapid. Either because demand was perceived to be insensitive to price or because of a reluctance of firms to challenge MGIC's price leadership, the initial pricing structure was maintained. Additional pricing options were developed, but they were essentially variations of the 1957 rate structure.

As the industry expanded during the 1970s, a number of new firms entered. By then, many of the larger firms had established a national base and were licensed in nearly all states. As a result, greater intra-industry competition began to develop. However, rather than competing for market share by lowering prices, insurers competed by offering additional services to lenders. Often this took the form of assistance in marketing mortgages to the secondary market and in providing training and marketing assistance to the lenders personnel relating to mortgage insurance.

Forms of intra-industry competition did not include direct price competition until about 1975, when one of the newer firms eliminated the $20 insurance application or review fee that had been standard in the industry for 18 years. Each of the firms within the industry immediately followed suit.

In analyzing price variability for mortgage insurance, it is important to distinguish between: (1) differences in price for a given product, and (2) differences in payment options for a given product. Sometimes the development of a new payment schedule may embody a price change so that the distinction between the two may not always be clear. Nevertheless, variation in prices and payment schedules must be differentiated. The latter primarily reflects product differences rather than price variation.

Price Competition

As already noted, through the mid 1970s, prices were uniform among providers for given insurance products and payment plans. Exhibit XI-12 shows variations in pricing in 1979 for the most popular insurance policy, 90/20 percent coverage (20 percent coverage of a loan in which a 10 percent down payment was made). In most cases, companies offered the same payment plans in each of the ten states. For MGIC, each of the six second tier companies, and four of the six third tier companies, prices are identical in all states for the two most popular payment plans (A and B). Exhibit XI-14 shows the distribution of payment plans across states by insurer for 90/20 coverages. Only PAMICO and commercial offer essentially similar plans (G, H and I in Exhibit XI-12) at lower than prevailing industry-wide prices.

Price variations for the newer, so called "closing saver" plans[1] are somewhat greater. Plans C (offered by PMI, AMI, Republic, Home, Commercial, and Commonwealth) and D (offered by VEREX, TICOR, Tiger, and Commercial) are identical except that C has lower up-front cost than D. MGIC did not offer any closing saver plans at the time of the survey.

Pamico, one of the two firms offering reduced prices for the 90/20 percent coverage, is a wholly-owned subsidiary of a parent group of Pennsylvania depository institutions. It authorized as a lender-owned insurer on the premise that it would provide rates below the prevailing market insurance rates. In those few areas where Pamico is an active insurer, it has offered rates that are up to 10 percent less expensive for the initial year, and about 12 percent less costly for renewals of 90/20 percent coverage. Similar reduced premium plans are available for other coverage categories.

Despite Pamico's price advantage, the firm has met only limited success in attempting to sell a lower priced product outside of Pennsylvania. According to many lenders, Pamico represents an insurer that is small, of low capitalization, highly concentrated, and unable to offer the full range of services offered by the larger competitors. As a result, the price reduction policies made available by Pamico have not been truly tested for market acceptance.

Although the incidence of price reductions has been relatively small to date, they do indicate that price competition is not entirely absent within the industry. During the survey of mortgage insurers conducted as part of this study, the insurers were asked their feelings concerning the degree to which price was instrumental in gaining or losing market share. Most of the individuals in the industry feel strongly that price changes made by any major competitor must be met in order to avoid a loss in market share. However, they also felt that any price reductions on their part would result in only a momentary gain in market share. They felt that the other firms would quickly meet their reductions and would quickly regain their lost shares.

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[1] The development of description of some of the different payout options are discussed below.

EXHIBIT XI-12

AVAILABLE PLANS FOR ANNUAL PREMIUM PAYMENT FOR 90/20 PERCENT COVERAGE (1) ALL INSURERS, 1980

Percent of Loan Amount

ALTERNATIVE PAYMENT PLANS	YEARS						
	1	2	3	4	. . .	9	10
A	0.50	0.25(u) →					→
B	0.50	0.24(o) →					→
I	0.45	0.22(o) →				0.12(o) →	→
G	0.35	0.25(u) →					→
H	0.35	0.24(o) →					→
C	0.29(o) → (Mandatory 10-year Term)						→
D	0.28(o) → (Mandatory 10-year Term)						→
E	0.35(u)	0.35(u)	0.35(u)	0.25(u) →			→
F	0.35(o)	0.35(o)	0.35(o)	0.24(o) →			→

(o) % of Original Principal Balance
(u) % of Unpaid Principal Balance

(1) Loans with up to a 90 percent loan-to-value ratio (LTVR) that are insured to the top 20 percent of the property value.

SOURCE: PMM&CO., 1980

Impact of State Rate Regulation

State rate regulation may play a role in reducing price competition. Seven of ten states for which we collected data were file-and-use states (refer to Exhibit XI-11). In Texas rates were fixed, while rates were not regulated in California and Colorado. Where rates have to be filed with regulatory authorities, an insurer cannot lower rates discretely but must announce to his competitors and to rate officials in other states that he is lowering rates. In an oligopoly with a single dominant firm (MGIC), this would likely discourage insurers from direct price competition. Instead of explicit price competition, when offering new plans or payment schedules insurers may try to increase their market share by lowering the rates from that which would be equivalent to the existing plans and rate schedules. This pattern, in fact, has been observed during the past few years.

The principal finding of this analysis is that prices tend to be uniform among the significant providers for the major insurance lines. The only deviations from price uniformity reflected lower prices changed by Pamico and Commercial, who together write less than one percent of insurance in the industry. There was some variation among major insurers for the less popular closing saver plans, and in fact these plans may be less costly than the standard plans (A and B in Exhibit XI-12) depending on present value assumptions used. This greater price variability for the closing saver plans may result from a lack of price leadership from MGIC which did not offer these payment plans for 90/20 policies.

As mentioned earlier, price uniformity can be indicative of perfect competition as well as monopoly or effective collusion. Is it likely that the observed price uniformity in the mortgage insurance market reflects an equilibrium price in a perfectly competitive market? The answer is clearly negative.

In a competitive market, the equilibrium price would change as market conditions changed, rising during periods of relative excess demand and falling during periods of excess supply. Prices for the primary mortgage insurance product have remained unchanged since the product was introduced, during periods of both rising and declining demand. Furthermore, they have remained unchanged across geographic market areas, despite differences in market conditions and claims loss experience. Other factors suggesting a lack of active price competition can also be cited, but the basic character of the market is already clear. It is a market lacking in active price competitive.

The lack of active price competition is no indication that mortgage insurers do not compete for business. They do compete in their offering variations in the mortgage insurance policy and in payment plans.

Variations in Products and Payment Plans

Until 1972, 20 percent coverage for a 90 percent LTVR loan and 25 percent coverage for a 95 percent LTVR loan both resulted in insurance on the top 28 percent of the property's appraised value.[1] With changes in FNMA and FHLMC requirements, insurance coverage in the amounts of 22 percent (for a 95 percent LTVR loan), 17 percent (for a 90 percent LTVR loan) and even 12 percent (for an 85 percent LTVR loan), all provided coverage for the top 25 percent of a property's value. In almost all cases, such reduced coverage was made available at a lower cost than that for the more common 20 percent or 25 perent coverage.

As the combinations of coverage and down payment increased the number of available insurance plans, significant changes were developing in the ways that borrowers could pay for such coverage. From 1957 on, two basic options were typically made available. One allowed for insurance premiums to be paid in annual installments, and the other allowed the entire mortgage insurance premium to be prepaid at time of settlement.

The annual or renewal premium plans have always been the more popular, and they have become even more frequent as most consumers dislike the prospect of paying as much as 2.5 percent of the loan amount (typical for 25 percent coverage for a 95 percent LTVR loan that is prepaid for 15 years) at the time of settlement. More than 70 percent of the lenders to whom we spoke used the annual or renewal premium plan 90 percent of the time or more. The insurers, however, indicated even greater use of the renewal plan. They basically agreed that only 5 to 10 percent of new premiums written are in the form of single premium plans.

Variations in payment of the annual premium plans have developed as insurers have attempted to design plans that: (1) are more simple to understand and to calculate premiums by, and (2) represent less costly settlement expenses. These plans do not necessarily suggest that they are cheaper, but rather that they represent an option of deferred premium payment.

Level payment plans allow annual premiums to remain constant during the full term of the insurance contract rather than declining proportionate to the outstanding principal balance of the loan amount. The level payment plan offered by most insurers (plan B in Exhibit XI-12) has the same first year's premium, but renewal premiums are 0.24 percent of the original loan amount instead of 0.25 percent of the outstanding balance (plan A in Exhibit XI-12).

The level payment plan, under all reasonable present value assumptions regarding discount interest rate and average length of time the insurance remains in force, represents a slight price reduction from the existing installment plan (plan A in Exhibit XI-12).

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[1] 20 percent coverage suggests that 80 percent of the 90 percent property value is uninsured, on 72 percent of the property value. For 25 percent coverage of a 95 percent LTVR, 71.25 percent of the property value is uninsured.

This alternative plan was received with some success by both lenders and borrowers, and now the level payment option has become nearly a standard throughout the industry. Interest in further reducing the amount of cash required at settlement to prepay the first year's premium has led to some new options in the terms governing premium payments.

In 1976, the "closing saver" plan was introduced as an attempt to reduce the costs to a home purchaser at settlement. It allowed, the premium paid at settlement for many plans to be reduced by up to 50 percent, with premiums required for years two and three (and sometimes four) to be increased by an appropriate amount. These plans have had some success for the insurers that make them available, but they have not been so successful that all firms have seen it necessary to add them to their product mix.

Some examples of these closing saver plans for 90/20 percent coverage are plans C, D, E, and F in Exhibit XI-12. Plans G and H offered by Commercial and plan I offered by Pamico are discount versions of and structually similar to the basic industry plans A and B.

Similar detailed and varied pricing alternatives are available for 95/25 percent coverage, for which we have identified as many as 12 different payment options across states. As Exhibit XI-13 indicates, Texas is the only state in which prices are established for all licensed insurers by the Insurance Commissioner. As a result, no variations are allowed with the exception of plans A and B for renewal payments. This suggests that some slightly reduced payment plans are not made available to Texas mortgagors, but a fixed rate structure like that of Texas is a much more easy one to administer.

Summary

Since its inception the mortgage insurance industry has been characterized by price leadership by a dominant firm and by uniform prices among major firms for the primary industry products. In recent years, however, new payment plans and rate structures have been introduced, which offer for the first time some limited characteristics of a competitive environment. Certainly pricing in the industry is becoming less rigid. However, in no sense can we infer that active price competition or workable competition prevails.

Our next task is to examine the characteristics of the environment in which mortgage insurance is purchased in order to understand why the market is not price competitive.

The Conditions of Reverse Competition

The marketing effort of the private mortgage insurance industry is designed around a system of reverse competition. Direct contact between insurer and consumer (i.e., home buyer) is almost entirely absent, and in the majority of cases, little consideration is given to consumer preferences. For practical purposes, the mortgage insurer considers the lender to be the consumer and appears more responsive to his concerns than those of the home buyer, who pays

EXHIBIT XI-13

DISTRIBUTION OF PLANS ACROSS SELECTED STATES BY INSURER FOR LTVR OF 90/20 PERCENT COVERAGE (1) (FALL, 1979)

PLAN AVAILABILITY BY STATE

FIRM	CALIF.	COL.	D.C.	FLA.	MD.	MASS.	MO.	TX.	VA.	WASH.
FIRST TIER:										
MGIC	A,B	A,B	A,B	A,B	A,B	A,B	A,B	A,B	A,B	A,B
SECOND TIER:										
UNITED	A,B	A,B	A,B	A,B	A,B	A,B	A,B	A,B	A,B,C	A,B
VEREX	A,B,D	A,B,D	A,B,D	A,B,D	A,B,D	A,B,D	A,B,D	A,B	A,B,D	A,B,D
TICOR	A,B,D	A,B	A,B,D	A,B,D	A,B,D	A,B,D	A,B	A,B	A,B,D	A,B,D
PMI	A,B,C	A,B	A,B,C	A,B,C	A,B,C	A,B,C	A,B	A,B	A,B,C	A,B
AMI	A,B	A,B,C	A,B,C	A,B,C	A,B,C	A,B,C	A,B,C	A,B	A,B,C	A,B,C
TIGER	A,B, D,E,F	A,B, D,E,F	A,B, D,E,F	A,B, D,E,F	A,B D,E,F	A,B, D,E,F	A,B, D,E,F	A,B	A,B, D,E,F	A,B,D
THIRD TIER:										
REPUBLIC	N/A (2)	N/A	A,B,C	A,B	A,B,C	N/A	A,B	A,B	A,B,C	N/A
FOREMOST	N/A	A,B	A,B	A,B	A,B	N/A	A,B	A,B	A,B	A,B
HOME	N/A	N/A	A,B,C	A,B,C	A,B,C	N/A	N/A	N/A	A,B,C	N/A
COMMERCIAL	N/A	G,H	G,H	G,H	G,H,C	G,H,D	G,H,C	A,B	G,H	N/A
PAMICO	N/A	N/A	I	I	I	N/A	N/A	N/A	N/A	I
COMMONWEALTH	A,B, C,E,F	A,B, E,F	A,B, E,F	A,B, E,F	A,B, E,F	N/A	N/A	A,B	A,B, E,F	N/A
INTEGON	N/A	A,B	N/A	A,B	N/A	N/A	A,B	A,B	A,B	N/A

(1) Plans A through I are detailed in Exhibit XI-12 on the preceding page.

(2) N/A signifies that the firm does not write mortgage insurance in that particular state.

SOURCE: State Insurance Commission Offices, Rate Filings.

for the services. Practices that characterize reverse competition work contrary to a competitive marketplace, but many representatives of both the lending and insurance industires argue that the current system provides greater efficiency than any alternatives. This section discusses both sides of that argument.

The Selection Process

Consumers, lenders, and insurers that we interviewed indicated a lack of agreement over the extent to which consumers participated in the selection of the mortgage insurer. Of the participants in the home buyers survey who purchased mortgage insurance, exactly half indicated they had some choice over the insurer. There was, however, significant variation in this response across geographic areas (see Exhibit XI-14). Among those given no choice, nearly two-thirds indicated the selection was made by the lender, and another 19 by the real estate agent or seller/builder (see Exhibit XI-15).

The lender interviews, however, pointed out that borrowers play a much less active role in the selection process. Nearly 80 percent indicated that they assumed full responsibility in all loans for the selection of the mortgage insurer (Exhibit XI-16), and only 16.4 percent indicated that the borrower is regularly allowed to participate in the selection (Exhibit XI-17). The distribution of answers to both of these questions varied substantially across geographic markets and somewhat less so across lender types.

Finally, the insurers themselves indicated they believed that the lender was almost exclusively responsible for their selection. Nine out of 14 attributed at least 99 percent of their business to the lender's selection; all 14 indicated that the lender was responsible for their selection at least 90 percent of the time. Four insurers reported, however, that up to 5 percent of their business was attributable to the decision of the real estate agent or the builder.

While these responses illustrate little consensus in attributing selection responsibility, they do suggest that consumer estimates of their own importance to the selection process may be over-stated, and that the home buyer may actually play a much less active role in the entire process. However, before too much responsibility can be attributed to the lender, the role played by the real estate agent should be considered.

Two distinct surveys were conducted of home buyers. One included discussions with home buyers in the eight SMSAs that were selected as sites for the study; the other included subsequent telephone interviews in 10 other cities. The results of these surveys strongly suggest that home buyers attribute more influence over the decision to select a mortgage insurer to the real estate agent than they do to the mortgage lender. In the first consumer survey, 25.2 percent of the total number of respondents interviewed identified the real estate agent as the party influencing (i.e., requiring or recommending) the selection of the insurer. Across both samples, this was greater than the number of lenders who required or recommended the mortgage insurer (see Exhibit XI-18).

EXHIBIT XI-14

PERCENT OF HOME BUYERS PURCHASING MORTGAGE INSURANCE WHO INDICATED THEY HAD A CHOICE IN THE SELECTION (SELECTED SMSAs; 1979 - 1980)

Boston	40.0%
Los Angeles	65.0
San Antonio	35.0
Washington, D.C.	36.7
Denver	62.2
St. Louis	59.3
Seattle	36.0
Jacksonville	63.6
Combined Total	50.0%

EXHIBIT XI-15

DISTRIBUTION OF PROVIDERS WHO SELECTED THE MORTGAGE INSURER (SELECTED SMSAs: 1979 - 1980)

Lender	66 %
Real Estate Agent	10
Seller/Builder	9
Attorney	6
Escrow Agent (1)	4
Other	5

(1) All observations occurred in Seattle.

SOURCE: PMM&CO. Home Buyer Surveys, February 1980.

EXHIBIT XI-16

PERCENT OF LENDERS WHO ASSUME RESPONSIBILITY IN ALL LOANS FOR SELECTION OF THE MORTGAGE INSURER (SELECTED SMSAs: 1979 - 1980)

(Percent)

COMBINED TOTAL	BOSTON	DENVER	W.D.C.	J'VILLE	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE
79.7	95.2	79.4	76.2	88.9	82.4	75.8	74.2	71.4

COMBINED TOTAL	COMMERCIAL BANKS	S&Ls	MSBs	MORTGAGE BANKS
79.7	80.0	86.5	100.0	67.1

SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT XI-17

PERCENT OF LENDERS THAT REGULARLY ALLOW BORROWERS TO PARTICIPATE IN SELECTION OF THE MORTGAGE INSURER (SELECTED SMSAs: 1979 - 1980)

(Percent)

COMBINED TOTAL	BOSTON	DENVER	W.D.C.	J'VILLE	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE
16.4	4.8	8.8	25.0	17.9	18.2	14.3	12.9	32.1

COMBINED TOTAL	COMMERCIAL BANKS	S&Ls	MSBs	MORTGAGE BANKS
16.4	14.3	9.0	20.0	28.3

SOURCE: PMM&CO. Lender Survey, February 1980.

EXHIBIT XI-18

FREQUENCIES DESCRIBING USE AND DISCUSSION OF MORTGAGE INSURANCE
(SELECTED SMSAs: 1979 - 1980)

	PERCENT OF ALL RESPONDENTS WHO BOUGHT PRIVATE MORTGAGE INSURANCE	PERCENT OF INSURANCE BUYERS WHO DISCUSSED MORTGAGE INSURANCE WITH SOMEONE	PERCENT OF BUYERS DISCUSSING MORTGAGE INSURANCE WITH WHOM THESE FACTORS WERE DISCUSSED		
			PRICE	POLICY DIFFERENCES	CANCELLATION
	(1)	(2)	(3)	(4)	(5)
Boston	25.6%	55.0%	100.0%	54.5%	20.0%
Los Angeles	31.3	29.4	100.0	40.0	20.0
San Antonio	27.0	63.2	70.0	40.0	20.0
District of Columbia	41.7	65.5	84.2	31.6	38.9
Denver	43.3	40.5	85.7	58.3	38.5
St. Louis	37.5	70.4	94.7	52.9	47.4
Seattle	32.1	56.0	100.0	53.8	61.5
Jacksonville	31.0	59.1	84.6	76.9	41.7
Combined Total	34.7	56.2	89.6	52.4	39.2

SOURCE: PMM&CO. Home Buyer Surveys, February 1980.

These figures are not comparable to those shown in earlier exhbits because the population (or denominator) includes all consumers interviewed, and not only those purchasing insurance. However, across the two distinct sets of interviews, there is consistency in both the questions and the responses. These results emphasize the role that the real estate agent may play in influencing the selection process. They also emphasize the fact that the consumer is in a vulnerable position when mortgage insurance is being purchased, and that at least two (nonexclusive) groups of providers are in a position to substantially influence the selection.

Improprieties Associated with Reverse Competition

The relative absence of the consumer in the process of selecting a mortgage insurer suggests an insensitivity to the product cost. There is little indication that the lender is as concerned with cost or as sensitive to cost differences among providers as the home buyer. In addition the existence of reverse competition allows conditions that encourage favors, kickbacks, and referral fees as a part of the marketing process.

The possibility of kickbacks, commissions, or referral fees exists any time a marketing effort is directed at any party other than the actual consumer. They are specifically deemed illegal by Section 8 of RESPA, and they are similarly prohibited by Section 4.10(a) and (b) of the NAIC Model Act. The members of mortgage insurance firms to whom we spoke indicated that the felt the industry did an effective job of policing itself on this matter, but that in some instances, violations might occur between an insurer's marketing representative and a lending officer. All firms indicated, however, that such practices were a violation of firm policy.

The use of favors, entertainment, and free services however, represents an accepted way of doing business within the industry. This does not justify such practices, and in fact, the entertainment element within the industry may suggest marketing expenditures that might be artificially high. Both lenders and insurers agree that such practices are frequent and difficult to suspend once loan officers come to expect them. The conditions surrounding reverse competition also create incentives for tied relations which unquestionably exist between the mortgage insurer and those in a position to refer business. The extent to which reverse competition occurs and its effects are discussed in a separate section below.

However, the current system requries that the consumer absorb the entire cost of these services, some of which benefit him only indirectly or not at all. Many of the free ancillary services that are provided lenders and that represent a basic component of the insurance product are designed to win customers by facilitating the processes of loan settlement and secondary marketing. A very sound case can be made that some of these services indirectly do benefit the home buyer by allowing for both a more efficient approval process and a less costly secondary marketing effort.

Efficiency and Reverse Competition

The conditions of reverse competition allow the consumer to be substantially circumvented in designing and delivering the mortgage insurance product. In so doing, significant costs associated with direct marketing to consumers are avoided, and it is highly likely that such costs would be significantly greater than those marketing costs currently borne by the industry. The mortgage insurers were asked how their marketing costs and overhead would be impacted by a requirement that the consumer choose the insurer. Nearly all responded that costs would increase substantially; most felt that pricing strategies would undergo change, but only one suggested that the industry would be able to absorb the added overhead without passing higher costs on to the consumer.

Were such a change to occur, it could place the smaller third tier firms at the greatest disadvantage. They are presently struggling with the smallest amount of market recognition, and they have the least resources to allocate toward an effective and competitive marketing campaign. Conversely, they might be able to increase their market share by aggressively pricing their products. It is difficult to believe, however, that the larger, more financially secure firms would not respond by lowering their own prices. While the outcome to this scenario is not clear, it could very well include lower prices for the consumer. It is clear that a primary focus of consumer advertising by the mortgage insurers would be price, or there is little else about the mortgage insurance product that is of concern to the consumer.

Summary

Reverse competition in the mortgage insurance industry likely results in higher prices and in more marketing abuses that add to cost than would exist if providers sold directly to informed consumers in a price competitive market. However, while clearly less than optimal, reverse competition may not necessarily result in higher prices than could reasonably be expected if the product were marketed directly to the consumer. Given the infrequent need by a consumer for mortgage insurance and indications from our interview data that consumers are often not very well informed about settlement service prices and product characteristics, the cost of mortgage insurance may not decline if direct consumer marketing prevails. Improvements in performance may depend on the robustness of price competition that develops, improvement in programs to educate the consumer about settlement characteristics and costs, and the willingness of state regulatory authorities to facilitate active price competition.

Reasonableness of Profits

The third element for evaluating the degree of workable competition within the industry considers the extent to which profits are reasonable and services are provided in a generally efficient manner.

If profits are unusually high over a sustained period, this suggests that prices are significantly above costs (including a market or normal return on investment) and workable competition does not prevail. Independent of the existance of workable competition, (we have already presented information which suggests it does not exist here) the evaluation of reasonableness of profits also provides an indication of whether prices are excessive. This is particularly important for a partially regulated industry, where active price competition may not exist and yet prices may not be unreasonably high.

The issue of industry profitability is tied closely to the contingency reserve requirement, which is unique to the mortgage insurance industry because it was designed to address a type of risk to which this industry is particurlarly vulnerable. All states require that 50 percent of all premium dollars earned be reserved for a period of 10 years before they can be touched. This reserve is designed to cover extraordinary or catastrophic losses, but to date no mature mortgage insurer has had to call upon this reserve to cover sustained losses.

It is not within the scope of this study to evaluate the reasonableness of this 50 percent reserve requirement. Two comments, however, are in order. In 1956, Wisconsin state law defined the contingency reserve which required that one-half of all earned premiums be set aside for 15 years (this requirement has since been reduced to ten years) in order to meet extraordinary losses. This requirement was based upon the statistical experience provided by the FHA's Mutual Insurance Fund (MMIF), upon recommendations made in the Alger Report in 1934, and upon a conservative approach by the Wisconsin insurance commission in attempting to define and adequate level of protection. No comprehensive evaluation by regulatory authorities has been initiated to determine whether this reserve requirement is excessive, and recent loss experience requests that it may be unnecessarily high.

However, the study prepared by Arthur D. Little in 1975 indicated that under simulated reverse or "catastrophic" economic conditions, the contingency reserve would become depleted despite the addition to it of half of all new earned premiums. Such assumptions did not reflect the inflationary environment that has benefited the mortgage insurance industry, but the results of the study suggest that reductions in the reserve requirement should be initiated after a comprehensive evaluation of their implications.

The ability of the industry to defer recognition of half of its earned premiums allows its earnings to be understated to the extent that its deferred liabilities will not be realized. This understatement of earnings, combined with the relatively strong earnings performance of the mature firms within the industry can lead to a conclusion that industry profits have been unusually high. In fact, a significant difference in financial performance has occurred among firms within the industry. However, the issue of whether the 50 percent reserve requirement is reasonable requires some discussion.

The mortgage insurance industry is designed to protect lenders against both underwriting loss, and more importantly, catastrophic loss that would result from a major economic recession or an act of God. In order to have the financial resources necessary to make payments on claims resulting from such catastrophes, substantial reserves and required.

At issue here is the question of whether the recent loss experience for the industry has been adeuate to justify either: (1) the current reserve requirements, or (2) current industry prices. A similar issue has been presented to the Wyoming State Supreme Court. The Office of the State Insurance Commissioner has filed a petition arguing that loss ratios within the State of Wyoming have been adequately low (over the last decade, Wyoming has had a lower loss ratio than any state in the nation) to justify reduced insurance premiums for mortgagors within the state. No decision has yet been reached, but evidence on national loss ratios that were presented as a part of that case illustrate the high degree of variability in loss ratios both across time and across states.

Exhibit XI-19 summarizes loss ratios for selected states and for selected periods during the 1970s. Nationally, loss ratios for nine insurers averaged 20.4 percent during the 1971-1976 period, reflecting the impact of a rather substantial housing slump and national recession during the middle of that period. Across the ten states within our sample, the loss ratio for that period ranged from a low of 7.1 percent in Virginia, to a high of 35.0 percent in Florida.

For each of the three years since 1976, national loss ratios for the mortgage insurance industry have declined, and were as low as 9.8 percent during 1979. In that year, no state reported a higher loss ratio than 14.9 percent (Massachusetts), and four of the ten states experienced loss ratios of 5.0 percent or less.

National industry ratios, however, do not indicate the major performance variables influencing a firm's profitability. The basic mortgage insurance activity requires that each firm prudently underwrite new loans and provide new coverage so that it contains losses and operates profitably. The insurer must fulfill a responsibility to the lender, who relies upon the ability of the insurer to stand behind the mortgagor to prevent or minimize a loss. The ability

EXHIBIT XI-19

LOSS RATIOS (1) FOR MORTGAGE INSURERS (2) NATIONAL, AND SELECTED STATES

1971 - 1979

Percentage

	1971 - 1979	1971 - 1976	1977 - 1979	1977	1978	1979
Combined National	15.1	20.4	11.2	14.5	10.3	9.8
California	11.2	22.5	4.7	5.0	4.4	4.8
Colorado	10.7	17.1	5.6	12.5	1.9	4.4
District of Columbia	14.2	8.1	20.4	26.4	25.0	11.7
Florida	30.0	35.0	25.9	56.3	27.1	5.0
Maryland	12.3	8.7	14.9	13.6	16.4	14.7
Massachusetts	26.0	28.7	24.1	41.8	23.0	14.9
Missouri	16.7	24.9	9.7	5.3	8.6	14.0
Texas	9.9	21.3	4.3	4.7	2.8	5.4
Virginia	11.4	7.1	14.6	16.3	14.7	13.4
Washington, D.C.	6.1	11.1	3.3	2.4	1.8	5.0

(1) Defined as direct losses incurred/direct premiums earned.

(2) Includes only those insurers licensed in Wyoming. These are AMI, Foremost, MGIC, Pamico, PMI, TICOR, Tiger, United and Verex.

SOURCE: Statistical Analysis, Wyoming Insurance Department.
Working papers prepared June, 1980.

of a firm to operate profitably is often measured by its underwriting ratio, which is defined as the sum of a firm's expense ratios over a given period of time.[1]

Exhibit XI-20 demonstrates that the expense ratio, which is basically the ratio of annual operating expenses to annual premiums written, has shown no perceivable pattern that is representative of all firms. This ratio has increased for seven of the firms including three among the top two tiers between 1978 and 1979, and for six of the firms between 1976 and 1979. This is noteworthy because of the substantial increase in premiums written over the past two years, suggesting that it has become increasingly expensive for these firms to conduct business. This may result from: (1) the greater range of services most firms are offering, and (2) greater marketing expenses resulting from more aggresive (nonprice) competition by more firms.

Two relatively new firms, Home and Commercial, have experienced significant declines in their expense ratios between 1976 and 1979. This is not surprising, due to the large start-up costs normally incurred in entering the industry. In 1976, both of these firms experienced expenses in excess of premiums written, and Commonwealth has recorded a similar experience in each year since 1977. This suggests that immediate profitable entry into this industry is extremely difficult. Without the financial backing of a well capitalized parent company, the entry of new firms into this industry may be substantially limited.

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[1] "Expense ratio" defines the relationship between underwriting expenses and premiums written during an accounting period. This ratio describes the overall operating efficiency of a firm, and it is also known as the operating ratio. Underwriting expenses include all noninvestment related expenses incurred by the firm, and premiums written include all new premiums realized by the firm during the accounting period. Investment income is not included in the denominator (premium written).

"Loss ratio" is defined as losses incurred/premiums earned during an accounting period. It describes the relationship between losses and premiums that are actually recognized as income during a period. It reflects a firm's ability to assess adequately underwriting risk, and a high loss ratio suggests that an insurer may be using questionable or imprudent underwriting practices. This ratio is also vulnerable to both natural and economic catastrophic events that may result in both unemployment and property loss.

"Underwriting ratio" is defined as the sum of a firm's loss ratio and its expense ratio. It is an indicator of how profitably a firm performed during an accounting period.

EXHIBIT XI-20

OPERATING RATIOS FOR MORTGAGE INSURERS 1976 - 1979

FIRM	EXPENSE RATIO				LOSS RATIO				UNDERWRITING RATIO			
	1976	1977	1978	1979	1976	1977	1978	1979	1976	1977	1978	1979
FIRST TIER:												
MGIC	.26	.36	.30	.31	.22	.16	.12	.12	.48	.52	.42	.43
SECOND TIER:												
UNITED	.43	.39	.34	.49	.17	.14	.14	.15	.60	.53	.48	.64
VEREX	.48	.54	.47	.43	.16	.11	.10	.13	.74	.65	.57	.56
TICOR	.60	.55	.49	.49	.15	.20	.12	.12	.75	.75	.61	.61
PMI	.71	.72	.71	.50	.19	.16	.16	.19	.90	.88	.87	.69
AMI	.36	.37	.47	.59	.11	.10	.07	.11	.47	.47	.54	.70
TIGER	.51	.47	.47	.44	.31	.22	.13	.14	.82	.69	.60	.58
THIRD TIER:												
REPUBLIC	.46	.48	.48	.62	.08	.13	.12	.10	.54	.61	.60	.72
FOREMOST	.82	.61	.65	.76	.12	.23	.16	.17	.94	.84	.81	.93
HOME	1.61	.42	.59	.53	.10	.17	.06	.17	1.71	.59	.63	.70
COMMERCIAL	4.32	1.79	1.24	1.67	.38	.11	.13	.15	4.70	1.90	1.37	1.82
PAMICO	.45	.69	.61	.67	.13	.16	.16	.13	.58	.85	.77	.80
COMMONWEALTH	N/A	4.06	1.60	1.20	N/A	.00	.05	.15	N/A	4.06	1.65	1.35
INTEGON	.62	.80	1.10	.85	.17	.18	.19	.15	.79	.98	1.29	1.00

N/A - Not Available.

SOURCE: 1976-79 NAIC Statutory Statements.

The loss ratios depicted in Exhibit XI-21 demonstrate a much more pronounced trend over the three-year period ending in 1978. Each of the seven firms in the top two tiers experienced a decline--for some firms, a substantial decline--in its loss ratio between 1976 and 1978. Among them, MGIC's declined from 22 percent to 12 percent; AMI's from 31 percent to 13 percent. Each of the third-tier firms was less successful in containing its losses. Increases in loss ratios between 1976 and 1978 were experienced by Republic, Foremost, Integon, and Pamico. During 1979, however, five of the top-tier firms and four of the third tier firms saw the loss ratio increase.

The performance of the smaller firms that experienced occasional increases in their loss ratios is explained by the greater volatility to which their smaller portfolios are subject. Because the insurance process involves the diversification of risk (and thus, loss) over a broad insurance base, those firms with a smaller base (that is, with less outstanding insurance in force) will experience a greater proportionate loss per claim. As a result, it is not surprising that the loss ratios among the smaller firms would be higher and more volatile.

Categories of Risk

For each of these firms, the loss ratio reflects realized losses due to two distinct categories of risk. The first of these is underwriting risk, which is inversely related to the quality of loans that are insured. As rivalry among insurers becomes more intense, lenders may pressure insurers to approve some marginally qualified potential mortgagors. Such practices, particularly during periods of easily available mortgage money, might increase the losses experienced by a particular insurer, but no data currently available suggest that this has yet happened. In fact, the experience to date of all insurers suggests that underwriting standards and quality control have been well maintained.

A second category of risk is that of loss due to a castastrophic event. The overall health and prosperity of the national economy have significantly reduced the actual losses experienced during the 1976-1978 period. However, more than half of the firms in the industry experienced high loss ratios in 1979 than during the prior year. It is premature to draw conclusions about the loss experience of the industry from this four-year period. The purpose of private mortgage insurance is to provide security for lenders against losses due to both natural and economic catastrophe, and no true test of the industry's capacity to provide such security has been presented during the past four years.

Although underwriting ratios have an important impact upon a firm's profitability, this can represent only a part of the picture needed to completely address the amount of reserves that are necessary. It is not within the scope of this study to evaluate the excessiveness of either industry profits or reserve levels. It is also premature to judge prices as being too high as a result of the very low loss ratios experienced by the industry over the past three years or by the generally lower underwriting ratios experienced during

EXHIBIT XI-21

ADVERTISING EXPENSE AS A PERCENTAGE OF TOTAL EXPENSE FOR THE MORTGAGE INSURANCE INDUSTRY AND FOR SELECTED FIRMS, 1972 - 79

YEAR	INDUSTRY AVERAGE	MGIC	UNITED	TICOR	PMI	CCMI	REPUBLIC
1972	6.6%	7.5%	6.3%	–	–	–	–
1973	6.1	8.4	3.2	1.0	3.2	–	19.0
1974	3.9	4.8	3.5	5.4	4.0	–	2.6
1975	3.5	3.6	2.5	3.7	3.9	.1	2.0
1976	3.6	4.3	1.4	2.8	3.3	4.8	2.2
1977	4.2	5.2	1.1	5.1	3.2	2.8	1.7
1978	3.6	4.5	3.2	4.7	1.6	6.9	2.0
1979	4.1	3.8	5.7	4.1	7.4	4.3	2.2

SOURCE: 1972 - 79 NAIC Statutory Statements.

1976-1978. It is important to note that during 1979, all but two firms (Integon and TICOR) within the industry experienced an increase in either the loss ratio, the underwriting ratio, or both. The A.D. Little study[1] that was prepared in April 1975 concluded that the financial reserves of the industry were adequate to withstand severe economic conditions, but that a simulation of a firm's performance under "catastrophic" economic conditions did result in a depletion of the contingency reserves of a simulated company. At that time, the issue regarding excessiveness of premiums and of reserves was not considered.

One cannot overlook the relationship that has developed over the last three or four years between very low loss ratios and the first true incidences of price competition within the industry. However, the small degree of price variability and the small decline in prices shown by some insurers would be inadequate to otherwise offset unreasonable profits should they exist. Nearly all insurance commissions in the states in which our interviews were conducted acknowledged that rates filed in those states are evaluated to see if they are "inadequate" or "excessive." At the time of our interviews, no state indicated that it was concerned with "excessive" charges (although since then, the State of Virginia has begun an investigation), but most of the offices of the state commissioners indicated that they place a very low priority upon the issue of mortgage insurance.

Summary

In our study of the industry, we were unable to determine that excessive profits are being earned or that the lack of workable competition is being impaired by unreasonable earnings by a small number of firms. To more comprehensively answer this question of excessive profits, a close evaluation of the 50 percent reserve requirement should be performed. Should loss ratios decline into the 1980s, we would agree that such an evaluation is warranted to determine an adequate level of protection against economic or catastrophic risk that the mortgage insurer should be called upon to provide.

DETERMINING ACCEPTABLE MARKET PERFORMANCE

Market performance is very much a function of the extent to which consumer interests are fulfilled and a product or service is delivered at a reasonable price. Despite the fact that active price competition or workable competition does not appear to exist in the market for mortgage insurance, other factors may contribute to acceptable market performance. While prices may be somewhat higher than would exist in a more price competitive enviroment, if the consumer is receiving quality and appropriate service and if abuses which may exist in other settlement service industries are not present here, overall market performance may be regarded as acceptable but qualified to some extent. This section evaluates the mortgage insurance industry in terms of a number of issues that directly impact consumer interests. These issues can be generally classified under the categories of: (1) market or product improprieties; (2) tied relationships within the industry; and (3) specific examples of consumer abuse.

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[1] The Private Mortgage Insurance Industry, Arthur D. Little, Inc., April 1975.

Market or Product Improprieties

During recent years, the mortgage insurance industry has manifested a certain amount of sensitivity to specific needs of lenders and consumers. As a result, the industry has performed well in terms of providing a range of products that can be more closely matched to the individual needs of the lender, and to some extent, the consumer.

An earlier section on price variability described how the industry developed a number of alternative products in order to meet the needs of a larger market and to preclude home buyers from paying for additional levels of insurance protection that might be unnecessary. However, the industry's performance with regard to packaging both the insurance product and a set of ancillary services does suggest market inefficiencies and may represent behavior that is specifically not in the interest of the consumer. Earlier, it was indicated that the additional services performed for lenders by the mortgage insurers are provided at no additional cost. Because the industry makes no attempt at marginal pricing for these components of the insurance product, no market mechanism exists to assure that they provide benefits to the lenders comparable in value to their cost. The lender will tend to request these services as long as they have some value to him, regardless of what they cost to provide.

The argument that the home buyer is the eventual beneficiary of these ancillary products is not without merit. There is no question that some of the services do help lenders to help consumers. It remains a legitimate point, however, that some of the services that are offered that are not related to assistance with secondary marketing may have little effective economic value, and were they required to pay for those services individually, many lenders might decline to do so. Without addressing the problems of implementation, which are formidable, we can say that a system designed to require unit or marginal pricing of ancillary services would likely be in the home buyers' interests, assuming the cost reductions are passed on to home buyers.

The discussion of reverse competition for this industry indicated that there are some efficiencies in marketing a product toward a small, focused population such as lenders, rather than toward as broad and diverse a group as is made up by home buyers. This marketing effort, however, has been criticized both within and outside the industry, as fostering a "wining and dining" attitude by both lenders and industry marketing executives. This practice is not specifically inappropriate, but to the extent that it is accommodated by high premiums paid by the consumer, they may represent unacceptable market performance.

Annual statements filed by each insurer with all Offices of the State Insurance Commissioners in the states in which they are licensed provide a consistent basis for comparison to determine whether advertising within the industry has become increasingly costly. If it has, this may suggest that inappropriate behavior may occur. Expense items included in annual statements are relatively imprecise, however, and are not prepared in accordance with generally accepted accounting principles. As a result, industry aggregates from this source provide only a general indication of market performance.

Exhibit XI-21 summarizes industry advertising ratios[1] as a percentage of total operating expenses as they appear in statements which each insurer must file with state insurance commissioners. Industry averages have generally declined somewhat significantly during the 1972-1979 period from 6.6 percent to 4.1 percent. The exhibit also presents similar advertising ratios for selected insurers during that period. These figures suggest that advertising ratios have generally declined for the larger firms within the industry, but that some of the smaller firms may experience greater variation due to their lower operating base. These figures do not support the assumption that the mortgage insurance industry allows unreasonable advertising expenses. Comparable data are not available, however, to assess the reasonableness of overall marketing expenses.

A question has been raised concerning the ability of the lender to negotiate lower than "market rates" for mortgage insurance coverage and to then charge the home buyer a higher rate. The pricing structure for mortgage insurance and the requirement of most states that all rates and policies be filed with the state insurance commissioner make it very difficult for lenders to misrepresent the cost of insurance to consumers. Furthermore, all of the insurers to whom we spoke indicated that they cannot "negotiate" the price of insurance with any of their customers because they are allowed to charge only rates that are filed with the insurance commissioner, and they must make those rates available to all lenders.

The Extent and Impact of Tied Relationships

Because of reverse competition in the market for mortgage insurance, there is a strong incentive to establish ties with those that directly purchase or can refer business to the insurer. Our interviews with mortgage insurers indicate that for nearly all of the larger firms in the top two tiers, no single lender accounted for much more than one percent of premiums. This would suggest that these firms are not beholden to any single or even small group of lenders. However, cultivating ties with lenders may still be one of the most effective marketing tools.

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[1] We have defined the advertising ratio as total advertising expenses (line 4 of Part 4, Expenses; Underwriting and Investment exhibit) divided by total expenses (line 17a of the same schedule).

During our interviews with the mortgage insurers, none indicated that he had members of his executive staff either acting in an advisory capacity or sitting on the board of directors of lending institutions. Although only limited influence can be attributed to it, it is not entirely uncommon for some representatives of lending institutions to sit on the board of the mortgage insurance firms. Exhibit XI-22 summarizes the composition of the board of directors for the 14 mortgage insurers as reported in their 1978 annual reports. As is indicated, about 43 percent of the total board membership is made up of members of the mortgage lending industry, and a large proportion of these are made up of board members of the smaller firms who can more effectively offer board memberships in an attempt to better penetrate a local market.

These board memberships do not necessarily, and do not likely, represent conflict-of-interest situations. Most of the insurers defend this practice by saying that the contribution made to a board of directors is independent of the business that is generated by their lending institution. However, the practice of maintaining advisory boards or committees is much more suggestive of a conflict of interests.

These advisory boards are composed almost entirely of regional groups of lenders who are brought together periodically (often semi-annually) to discuss relevant issues. These meetings are not without merit, but even from within the industry, this practice is criticized as a questionable method of soliciting business. The trade association of mortgage insurers, MICA, has taken a position against this practice, and it is now used less frequently than it had been a few years ago.

Section 4.12 of the NAIC Model Act (see Appendix E) prohibits conflict-of-interest situations. Although the Act has been adopted in its entirety by only two states, it has the strong support of MICA. The Act also prohibits another potential abuse available to mortgage insurers in attempting to influence lenders. Section 4.11 prohibits the use of compensating balances, or the maintenance of funds on deposit with any lender for whom the insurance company has insured loans.

We asked mortgage insurers the extent to which they could invest in the securities or obligations of lending institutions with whom they do business. Only one of the 14 insurers admitted to such a practice; all others were prevented by either state law, internal policy or investment objectives. In the one case where such an investment was held, it amounted to less than one percent of the insurer's investment assets.

Other Practices At Issue

Lack of direct contact between the mortgage insurer and the consumer increases the possibility of higher than competitive charges. To the extent that the borrower may incur excess charges in his purchase of the mortgage insurance product, it is more likely to be the lender, rather than the insurer, who is the instrument of that injury. Chapter X provides a more detailed discussion of the frequency of lender self-insurance and cancellation policies for terminating mortgage insurance.

EXHIBIT XI-22

COMPOSITION OF BOARD OF DIRECTORS, ALL MORTGAGE INSURANCE FIRMS, 1978

	BOARD OF DIRECTORS INFORMATION							
PRIVATE MORTGAGE USERS	MORTGAGE BANKER	THRIFT INSTITUTION	COMMERCIAL BANKER	BUILDER/ ATTORNEY	IN HOUSE/ AFFILIATE MGMT.	OTHER	TOTAL	CORPORATE HOLDING COMPANY STATUS
FIRST TIER								
MGIC		5		1	3	3	12	99.9% of MGIC's outstanding stock is owned by MGIC Investment Corporation.
SECOND TIER								
UNITED		3	1	5	2	2	13	Wholly owned by United Guaranty Corporation of North Carolina.
VEREX	2	7		1	2	2	14	Wholly owned by VEREX Corporation which is wholly owned by Greyhound of Arizona.
TICOR	1	3	1	1	6		12	Wholly owned by Title Insurance and Trust Company.
PMI					5	4	9	Wholly owned subsidiary of Allstate Insurance Company, Inc.
AMI		3			2	2	7	Wholly owned by AMIC Corporation of North Carolina which is wholly owned by Merrill Lynch Co.
TIGER	3	14		1	1	4	23	Controlled by Tiger Insurance Group, Inc. which is a wholly owned subsidiary of Tiger International.
THIRD TIER								
REPUBLIC		13			2		15	Wholly owned by RMIC of North Carolina.
FOREMOST				1	6	3	10	Wholly owned by Foremost Insurance Co. of Michigan.
HOME		7		1	1		9	Wholly owned by HGIC Corporation of Virginia
COMMERCIAL				1	9		10	All outstanding stock owned by Cavalier Insurance Co. which is a subsidiary of Control Data Corporation.
PAMICO		5		1	1	1	8	Wholly owned by Pennsylvania Thrift Services, Inc.
COMMONWEALTH					8		8	Wholly owned by Commonwealth Land Title Insurance Co. which is wholly owned by Reliance Group, Inc.
INTEGON					8		8	Wholly owned by Integon Corporation
Totals	6	60	2	13	56	21	158	
Percent of Total	3.8	38.0	1.3	8.2	35.4	13.3	100.0	

SOURCE: 1978 Annual Reports.

One of the greatest consumer concerns regarding mortgage insurance has been the terms of policy cancellation. The mortgage insurers we interviewed responded unanimously that a policy can be cancelled at any time after it has been originated. The only exception to this rule relates to some of the newer, reduced front-end policies that require that coverage be maintained through some specific number of years; it is not altogether clear whether the lender will be held liable for the terms of this policy should the borrower decide to prepay the loan.

Because the decision regarding permission to cancel a policy rests in the hands of the lender (or the investor whom he represents), this does not represent a potential area of abuse by the insurer. However, it is reverse competition that causes this problem. The lender retains the responsibility to determine if the policy is still required, yet he has no economic incentive to consider cancelling the policy. The natural inclination of many lenders may be to follow the more cautious path and retain the mortgage insurance even though it may be no longer necessary.

All insurers responded that when a policy is cancelled they send unearned premiums directly to the borrower. When the borrower's address is unavailable, however, the premiums may be sent to the lender, and he becomes responsible for their rightful distribution. Four of the 14 insurers indicated that they take active steps to assure that the lender will refund the unearned premiums to the borrower. These may include either issuing a joint check to both lender and borrower, or attempting to notify the borrower that the lender has received the refund. These steps are, unfortunately, not a common practice within the industry, and their more prevalent use would contribute to reducing the opportunity for lender retention of the refunds.

CONCLUSIONS

There are striking similarities between the development of the private mortgage insurance industry and the traditional product life cycle that is presented in contemporary marketing literature.[1] The residential mortgage insurance business, as we know it today, began with the licensing of one company (MGIC) in the late 1950s. The industry experienced a period of restrained growth between 1959 and the late 1960s. During those ten years, the monopoly that MGIC had developed was transformed into an oligopoly of five firms. The demand for low-down payment mortgages expanded during that time, and with it, the demand for mortgage insurance. There is, however, no evidence of insurance price reductions during this period, and competition was significantly reduced by MGIC's maintenance of a predominant market position.

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[1] Chester R. Wasson, Dynamic Competitive Strategy and Product Life Cycles (St. Charles, Illinois: Challenge Books, 1974); and Philip Kotler, Marketing Management (Englewood Cliffs; Prentice-Hall, 1976).

Beginning in about 1970, the industry entered a stage of near exponential growth that was fueled by: (1) the passage of the Emergency Home Finance Act, which expanded the secondary market; (2) capital market conditions that favored the marketability of privately insured loans: and (3) macroeconomic and demographic conditions that stimulated an increased demand for housing. During the period between 1970 and 1980, the private mortgage insurance industry:

- increased from 5 to 14 in number of firms;
- increased more than tenfold the total insurance in force;
- surpassed the Federal Housing Administration (FHA) in total single-family mortgage insurance in force; and
- witnessed a proliferation of ancillary products and services aimed at securing insurance business with lenders.

According to much contemporary marketing theory, the stage of rapid market growth and fulfillment of pent-up demand which the mortgage insurance industry has been experiencing may typically be followed by a period of increasing competitiveness, and then a period that might be referred to as saturated maturity when demand has been satisfied and expansion becomes more difficult. Although it is conjecture, the private mortgage insurance industry may be nearing the end of its stage of rapid market growth and about to enter one of "competitive turbulence,"[1] in which growth may decline to a rate more closely approximating that of the overall housing market.

If this is the case, significant change in the performance of the mortgage insurance industry is likely to result. The industry as it is currently structured does not favor the development of elements of pure competition. Market information is available but is substantially blurred through the process of reverse competition, and although no explicit entry barriers exist, capital requirements suggest that the industry is not likely to see new entrants. Perhaps most important, the buyer (lender) of insurance has little incentive to be concerned about receiving the lowest price for the consumer (home buyer) who pays for the insurance.

Although the industry has seen some limited price deviations from industry-wide pricing levels, this is not enough to rate the industry highly with regard to active price competition, or what we have termed "workable competition." First, consumers would have to be substantially better informed about mortgage insurance and about payment schedules and prices offered by different providers. Second, the nature of rate regulation in most states would likely also have to change from file-and-use to open competition. If these changes were to occur, there is a high probability in our judgment that more active price competition would prevail and costs to the home buyer would decline.

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[1] Wasson, Competitive Strategy.

Without better informed consumers and a regulatory environment more conducive to active price competition, there is some danger that direct marketing to the consumer could result in even higher mortgage insurance costs. Many consumers would still require referral services from providers and a network of private mortgage insurance agencies or salesmen could develop whose commissions would add to the cost.

Are mortgage insurance premiums too high? This issue is central to an evaluation of market performance. It would appear so, considering the low loss ratios (average of 15 percent) experienced during the 1970s and the ability of the major insurers to offer a broad range of services to lenders for the current insurance premium charged to home buyers.

The issue of reasonableness of prices is clearly related to reasonableness of profits. Compounding an evaluation of profits, however, is our inability to conclude whether profits are excessive because of their sensitivity to reserve requirements. We did not undertake to define the level of risk of severe economic depression and associated deflation of housing prices that private mortgage insurance should provide protection for. This analysis would be required to evaluate the appropriateness of current reserve requirements. We did note that the 50 percent reserve requirement has not changed since it was implemented in 1957 and that it require reserves that are obviously related to premiums but not to levels of risk and insurer exposure.

There is no significant indication of excessive levels either of advertising or marketing expenditures, and no evidence was uncovered of either explicit referral fees or implicit referral fees (high commissions).

The sum of the evidence suggests that private mortgage insurance premiums are higher than necessary to provide the insurance product. This would argue for a reexamination of mortgage insurance rates by state insurance commissioners.

The industry structure is becoming less concentrated; by nature of the growth by the second tier of firms at the expense of MGIC. As a result of this, it is likely that more examples of price competition will develop. We were unable to adequately assess the reasonableness of profits and the appropriateness of the 50 percent reserve, but a future reassessment of the current reserve requirements may be in order if the industry's annual loss ratio continues to decline as it has during the past three years.

The process of the lender rather than the home buyer selecting a mortgage insurer remains a major impediment to workable competition, but there is no clear case to indicate that the consumer would be better off if he dealt directly with the mortgage insurer, unless certain significant changes occurred.

Finally some problems have been identified as possible objections to acceptable market performance although they do not appear to be either frequent or severe enough to warrant major corrective action. Problems that have occurred with regard to refunds for unearned prepaid premiums of maintenance of insurance coverage when no longer necessary are of greater concern to the lending industry and may be well solved through state regulation (as in the case of a bill before the Virginia General Assembly).

In summary, the industry has been successful in delivering a product that has provided many consumers the opportunity of home ownership. However, while it has done so at a cost that is above the lowest possible cost of production and above that which would exist in a price competitive marketplace, it may not be higher than what would exist under direct marketing to consumers without significant changes in consumer sophistication and in state rate regulation.

The overall performance of the market for private mortgage insurance can be considered fair, rather than either poor or good. Prices are somewhat higher than they might be and some abuses do exist as a result of reverse competition.

XII. THE TITLE ASSURANCE AND CONVEYANCING INDUSTRIES

This section considers those industries and groups that provide both title assurance and conveyancing services. The discussion of traditional title assurance functions, such as title search, title examination, title insurance, and attorney's opinion of title is supplemented by a discussion of the conveyancing functions, settlement, escrow, and the preparation of documents.[1] Strictly speaking, the conveyancing services are not a part of the title assurance process. However, the charges for these services are often calculated or reported in a manner that prevents an accurate or meaningful separation. In addition, the title insurance companies and attorneys who provide title assurance often conduct settlement and prepare documents in many parts of the country. Thus one provider collects fees for several functions.

The markets for the provision of title assurance and conveyancing services may be considered at two levels: (1) the primary or local market, which often includes many different types of providers; and (2) the national market, which for the most part comprises the title insurance underwriters. Both markets will be analyzed in this section, although the major emphasis is on the primary market where the consumer actually pays for and receives title assurance services.

The basic forms of title assurance, the types of conveyancing services, and the providers of these services were described in Chapter V. This section presents the findings of this study relating pricing and efficiency in the provision of these services. Local markets differ in many respects. There is considerable variation from state to state in the regulation of title insurance, as well as in the rules governing the unauthorized practice of law. There is also variation in use of attorneys in the transfer of real estate. The sites may also differ in a number of other characteristics, such as in the roles of lenders and brokers as referrers of title services and as settlement agents themselves. The issue of whether these practices affect prices to consumers is addressed in this section.

This chapter is divided into four major sections. The first discusses title assurance in terms of the criteria for perfect competition provided in Chapter VII. The second section attempts to determine the existence of workable competition in title insurance markets and presents findings on price variations both within markets and between markets with different regulations and practices. The third section analyzes the cost of providing the title assurance services and the relationships of these costs to total revenues. Finally the fourth section analyzes issues regarding the legal profession.

TITLE INSURANCE AND THE CRITERIA FOR PURE COMPETITION

Chapter VII presented four criteria which need to be satisfied in order for the market of a given product or service to be characterized as having pure or perfect competition. Where perfect competition exists, competitive market pressures force suppliers to provide the product or service at the lowest possible cost of production.[1] Where these criteria are only partially satisfied, but active price competition appears to prevail to a reasonable extent, "workable competition" may be said to exist. This too can assure that the buyer is receiving demanded products at a reasonable cost. However, if workable competition does not exist, there is a potential for high prices, excess profit, and poor market performance.

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[1] As in Chapter VI, the term "title assurance" will include the search and examination as well as Title Insurance. Conveyancing services include settlement or closing, escrow and document preparation.

Homogeneous Product

One assumption of a purely competitive model is that the product produced by different suppliers is undifferentiated or homogeneous. Product quality or characteritics of the individual supplier are undifferentiated by the buyer because each producer sends identical goods to the market. An example of this is found in the markets for many agricultural products. Most other markets, however, exhibit this characteristic only to varying degrees.

Title assurance, from the consumer's perspective, is a homogeneous product. While one firm may conduct a better title search than another one, a consumer is generally not in a position to judge performance even if he is reasonably well informed about title insurance. Usually a time lag of many years occurs between poor quality work and the increased insurance claims or diminished reputation which may result. These results should be reflected in higher loss ratios, but those data are not communicated to the public.

Furthermore, a consumer rarely has a real choice between the different forms of title assurance: an attorney's opinion of title or a policy of title insurance. While both forms may be available in some specific markets, it is usually another provider of settlement services who determines the form of title assurance to be used.[2] A lender, for example, who wants title insurance on the mortgages he originates, perhaps to satisfy secondary market requirements, may not accept an attorney's opinion of title. Similiarly, a lender who is willing to use an attorney's opinion may specify the individual attorney from whom he will accept an opinion. A consumer who wants a policy of title insurance may have to arrange--and pay--for that service separately. Thus, while different forms of title assurance exist, they are not usually avialable for a given mortgage transaction.

Though title insurance can be viewed from the consumer's viewpoint as being a fairly homogoneous product, there is an important exception. The services of an attorney or other party involving assisting in writing the negotiation, selecting other settlement providers, or providing other non-procedural services may not be homogeneous. Real or perceived differences in quality may be an important factor in the choice of this provider.

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[1] This would include a normal or market return on invested capital, or profit.

[2] In many areas, only one form of title assurance is available, unless a determined consumer undertakes extraordinary efforts to obtain the form which is not used in that area.

Numerous Independent Buyers and Sellers

Pure competition suggests that no single buyer or seller is large enough to influence market prices. This situation occurs only when numerous buyers and sellers are operating independently of one another. Many local markets may not meet this criterion.

Market shares and concentration ratios are useful in profiling an industry and in identifying the firms that may be in a position to dominate market pricing and product quality. Such firms can reduce the forces of competition. The data may also explain the pricing behavior actually observed in the market. These statistics alone, however, cannot definitively reveal anything more than the potential for domination by an individual firm or small group of firms.

The market for title assurance cannot easily be defined in terms of traditional market concentration analysis. Exhibit XII-1 (also presented in Chapter V) demonstrates clearly the difference between the title insurance underwriter market and the local markets in which consumers operate. Title insurance underwriters may usefully be considered in terms of a wholesale industry. The retailers are branches and agencies, attorneys, and underwritten title companies.[1] The buyer's contact is with the retailer. (In some cases, the retailer is, in fact, a branch office of a national firm).

High concentration at the wholesale level may lead to formal or informal attempts to fix prices, which could translate into higher prices for the consumer. In the case of title insurance, such informal understandings may be reflected in the common rate schedule used (for the risk or insurance premium only) in many places throughout the country.[2]

Appendix F lists the 15 largest title insurance-underwriting companies operating in the United States. Many individual title insurance underwriters are owned by a common parent corporation and therefore cannot be considered separate, competing entities. For this reason, market shares are calculated on the dollar value of direct title insurance premiums written by all of the companies under one corporate ownership. The position of these underwriting firms within the sample states is presented in Appendix G. This information is summarized in Exhibits XII-2 and XII-3.

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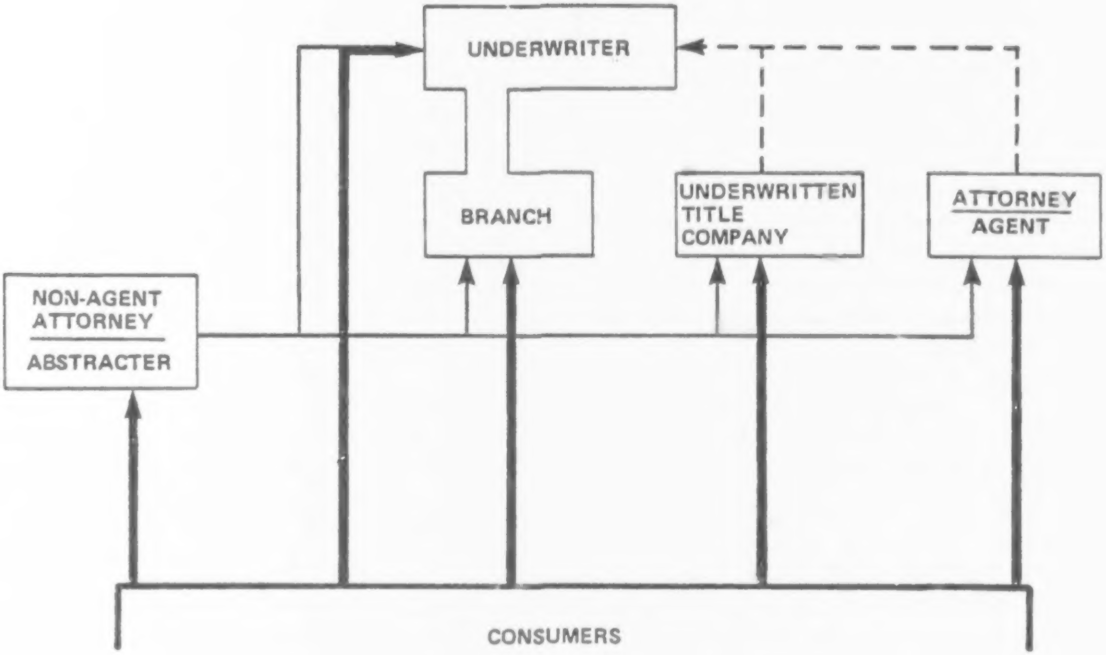
[1] In this report, as elsewhere, the term "title insurance company" will refer to an underwriter. The term "title company" will refer to a firm which sells title insurance but does not accept risk.

[2] The National Title Insurance rate schedule has developed historically. It is used in many places but by no means in all. The cost for title insurance alone, both mortgage and owners, would be $210.00 on a $60,000 house.

EXHIBIT XII-1

ALTERNATIVE PATHS AND FLOWS OF PAYMENTS FOR TITLE INSURANCE


UNDERWRITER
BRANCH
UNDERWRITTEN TITLE COMPANY
ATTORNEY
AGENT
NON-AGENT ATTORNEY
ABSTRACTER
CONSUMERS

━━━▶ Total funds paid to the listed provider, including premium paid for title insurance policy, and charge, if any, for title search.

───▶ Premiums paid to the selected title insurance provider by non-agent attorneys and abstracters that are nc affiliated with an underwriter.

SOURCE: PMM&CO., 1980

– – – ▶ Premiums, less commissions, paid to underwriter by the Underwritten Title Company or attorney/agent.

EXHIBIT XII-2

CONCENTRATION INFORMATION ON THE TEN RELEVANT SITES

STATE	Concentration Ratios			TOTAL STATE DIRECT PREMIUMS WRITTEN ($)	TOTAL NO. OF FIRMS
	LARGEST FIRMS MARKET SHARES (%)	FOUR-FIRM (%)	EIGHT-FIRM (%)		
CA	30.98	81.22	97.24	241,514,977	13
CO	50.24	74.46	92.64	24,880,347	12
DC	31.06	78.76	88.61	3,749,230	13
MD	22.85	59.68	88.29	16,049,502	15
VA	83.63	71.53	90.79	17,859,111	17
FL	14.64	50.21	76.30	49,062,271	25
MA	33.28	87.20	98.99	2,075,601	10
MO	23.03	68.62	97.94	14,234,228	10
TX	22.50	64.60	90.76	146,171,062	13
WA	32.76	93.71	100.00	50,854,607	6
Averages:	29.81	74.85	92.79	66,567,790	12.75

Source: Compiled by Peat, Marwick, Mitchell & Co. from annual statutory statements (Form-9's) filed by Title Insurance Companies with State Insurance Commissioners.

EXHIBIT XII-3

DISTRIBUTION OF STATE HIGH-SHARE FIRMS: MKT. SHARE RANK/MKT. SHARE

Firm Home State	CA	CC	DC	MD	VA	FL	MA	MO	TX	WA
TI & Trust Co.	1 / 30%	3 / 9%		4 / 11%	2 / 15%		3 / 19%	3 / 17%	4 / 11%	1 / 33%
SAFECO TIC (LA)	2 / 26%									2 / 30%
First American TIC	13 / 13%									4 / 7%
Transamerica TIC (S.F., CA)	4 / 10%	1 / 50%								3 / 24%
Chicago TIC (Chicago, Ill.)		2 / 9%	3 / 14%		4 / 11%	1 / 15%	2 / 20%	1 / 23%		
Lawyers TG Fund						3 / 13%				
Fidelity National		4 / 7%								
District-Realty (DC)			1 / 31%	2 / 14%						
Commonwealth Land (PA)			2 / 25%	3 / 13%	3 / 12%					
Lawyers TIC (Rich., VA)			4 / 9%		1 / 33%	2 / 14%	1 / 33%			
American (Miami, FL)						4 / 9%	4 / 16%			
St. Paul TIC (St. Paul, MN)								2 / 17%		
Stewart TGC (Houston, TX)									1 / 23%	
TIC Of MN. (Minn., MN.)								4 / 12%	2 / 18%	
US LIFE TIC (Dallas, TX)									3 / 13%	
Title Guaranty Co. of Baltimore				1 / 23%						
4 Firm Concentration Ratio	80%	74%	79%			50%	88%	69%	65%	94%

SOURCE: Compiled by Peat, Marwick, Mitchell & Co. from annual statutory statement (Form-9's) filed by Title Insurance Companies with State Insurance Commissioners.

The four-firm concentration ratio, both nationally and in each of the states of this study, is over 50 percent. This ratio is often used to indicate the presence of oligopoly in an industry when the leading four firms control 40 percent or more of the total market.[1] Markets characterized by oligopoly sometimes exhibit some form of active collusion or informal understanding regarding prices; overt price cutting is generally not used as a method of competition.

Traditional concentration ratios of title insurance underwriters do not present the reality of the market, however, if underwriters do not sell directly to consumers. In many markets, insurance is sold through attorney-agents or underwritten title companies. From the consumer's perspective, the result is that, the title insurance provider is the attorney-agent, independent title company, or other party from whom he directly purchases title insurance.

In the local or retail market for title insurance, the number of providers varies by site. Where attorneys are used extensively for conveyancing, there are a large number of providers; however, the choice of a particular provider may be limited by the lending institution. In markets where title insurance branches sell insurance directly, the number of providers is more limited. An extreme example is Seattle, which has only six title insurance providers.

Clearly, the concept of oligopoly must be used very carefully. At the underwriter level, there are only a few firms supplying a large share of the market. At the local level, however, the structure of the market may vary considerably and each should be individually examined.

Barriers to Entry

Pure competition assumes that participants are free to enter and exit the market. This implies that if profits are high in an industry, new producers will open operations, the supply of goods or services will be increased, and the equilibrium price in the market will fall. The concept of barriers to entry in the title insurance industry may be applied both at the underwriter level and the primary provider level.

For insurance underwriters, most states have required (capital) loss reserves. These requirements, which are set for all lines of insurance, generally reflect the insurance commission's stated purpose: to guarantee that the firms are solvent and that funds are available if losses are unexpectedly high in some time periods. Nevertheless, there are over 25 title insurance underwriter groups in the United States, ranging in size from $199 million to less than $100 thousand in premiums collected during 1978. Entry into this field certainly requires some capital but does not seem to be more restricted than other lines of insurance. The more relevant barriers to entry are those at the primary provider or local level.

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[1] F.M.Scherer, Industrial Market Structure and Economic Performance, (Chicago: Rand McNally College Publishing Company, 1970).

One type of local barrier is presented by unauthorized practice of law regulations, as discussed in Chapter V. Where these rules exist, title companies, realtors and lenders are restrained from performing certain functions, and prices might thus be higher than if the supply of providers were not restricted. (This is examined later in this chapter.) Another barrier to entry is the entrenched referral patterns which prohibit new firms from gaining access to customers. The patterns in many cases can only be broken if referrers are offered better terms by the title assurance providers.

Another type of barrier to entry is the requirement in some states, including Texas and Washington, that title companies develop and maintain a title plant. Due in part to this requirement, there are only six title companies in Seattle. For an underwriter to enter the Seattle market and provide searches as well as insurance, it must either buy an existing plant or create one, either of which is extremely costly. Abstracters and attorneys who provide title assurance in Washington State outside of Seattle are not subject to the title plant requirement. The Texas requirement is less restrictive. Title plants can be shared and data collection may be informal. Thus, the number of title companies in that state is 13.

While these barriers to entry may hamper competition in some local areas, it is doubtful that in most localities entry to the title insurance industry has been significantly restricted by artificial barriers. While regulations differ by state and by area, for the most part the basic requirements are not burdensome.

Well-Informed Consumers

One of the more crucial assumptions of perfect competition is that both buyers and sellers are well informed about the product and market conditions. This assumption does not hold with regard to title assurance or conveyancing services. Chapter VIII presented a thorough discussion of the lack of consumer knowledge of settlement services. In this section therefore, we will briefly point out that title assurance is purchased only infrequently, it seems complex to the layman, and most consumers do not take the time and effort to become knowledgeable about either products, prices, providers, or title insurance markets.

The PMM&Co. survey indicated that only 11 percent of the home buyers interviewed had spoken with more than one title insurance company. Of the 21 percent who hired an attorney, only 18 percent talked with more than one.[1] These responses suggest that most consumers do not make the effort to shop for lower prices.[2]

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[1] In the few areas where there is a choice of going through an attorney-agent or branch, it was not clear whether consumers compared the two. This is not usually an option.

[2] These figures resulted from the PMM personal surveys. The telephone survey results were quite close to the personal survey.

One explanation commonly given for the lack of shopping is that consumers believe prices and services are all uniform. However, of the consumers who did shop for these services, 73 percent thought it worthwhile to shop for title insurance companies, and 81 percent to shop for attorneys. Apparently, these buyers felt that they were able to find better prices and services through comparative shopping.

Nevertheless, most consumers that we interviewed did not shop. Many relied on recommendations from real estate agents and lenders. This is the primary characteristic of the market condition known as reverse competition. (A rigorous economic definition of reverse competition was presented in Chapter VIII.) Even if all other prerequisites for pure competition had been met, pure competition would not exist if the use of intermediaries led to reverse competition.

Summary

The four criteria for perfect competition appear to be partially satisfied in the title assurance industry.

From the consumer's perspective, the title assurance product is homogenous. Barriers to entry, while variable by state, do not appear to significantly deter title insurance underwriters from entering the industry. However, in many states and localities at the retail or direct consumer provider level, artificial barriers do exist which restrict entry, sometimes from a whole class of providers. There is ample evidence that buyers are not well informed about prices, providers, and market conditions. Reliance on brokers, lenders and attorneys has led to the situation known as reverse competition (by which competition is for referrals and not customers).

WORKABLE COMPETITION

Pure or perfect competition is an ideal not likely to be achieved in any settlement service market, nor indeed in most other product markets. However, it is critical when evaluating market performance to seek to determine if active price competition or what may be called "workable competion" exists. Where workable competition prevails, suppliers of services would be forced by the pressures of a price competitive market to provide their product or service at a price which is close to the lowest possible cost of production.[1] As discussed in Chapter VII, the criteria for workable competition cannot be precisely defined, but they include some degree of satisfying the four conditions for pure competition, plus evidence of competitive pricing among providers and other indications that services are being provided efficiently and at reasonable cost.

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[1] This would include a market rate of return on investment or profit.

Pricing of Title Assurance and Conveyancing Services

The price that a consumer pays for title assurance and conveyancing services can vary substantially from one location to another, and often among providers in the same locale. Variation often occurs in charges for title search, other title-related services, and conveyancing services rather than in the title insurance or risk premium itself. This section presents data from two sources on prices within the eight SMSAs selected for this study. The principal data source is Uniform Settlement Forms (HUD-1s). In this analysis, data from transactions with a sales price between \$55,000 and \$65,000 are presented. A second source is a set of estimated prices which PMM&Co. developed from provider interviews for the cost of the same services on a \$60,000 house in each site.

Because title assurance charges are based on house selling price, an average of all available transactions would have reflected cost of housing in an area rather than the cost of services. It was therefore necessary to choose a narrow band of home sales prices so that a meaningful comparison could be made across sites. The \$60,000 sales price chosen was near the average for the eight SMSAs. When analyzing the HUD-1 data, an appropriate range of \$60,000 plus or minus \$5,000 was used in order to obtain enough observations for meaningful descriptive statistics.

The data represent the total of all title and conveyancing charges. In addition, two breakdowns are also presented; (1) the total of all fees specifically identified for title assurance, including search, examination and insurance; and (2) the total of all fees for conveyancing services, which include the charges for conducting settlement, escrow, document preparation, and attorney's fees. We tend to focus on the total of all title and conveyancing charges because some providers do not explicitly charge for conveyancing, while others that do, may list the total charges under one category or the other.

HUD-1 Pricing Data

The survey of HUD-1 forms, which has been described in considerable detail in Chapter I, is the best source of information on charges actually paid by consumers for title and conveyancing services. The HUD-1 pricing data collected for the period late 1978 and early 1979 for each of the selected sample SMSAs is presented in Exhibit XII-4.

The mean charges on the HUD-1 data do not accurately reflect what a consumer would expect to pay for these services in a given area. The data have some unique characteristics:

- The HUD-1 pricing data include the amounts paid for special or unusual legal services. As a result, they may be biased upwards as an estimation of the price of a routine or typical transaction.

EXHIBIT XII-4

HUD-1 PRICING DATA – ALL SITES TITLE ASSURANCE AND CONVEYANCING (1100 SERIES)

For Transactions With Contract Sales Price Between $55,000 and $65,000

SMSA	BOSTON	DENVER	WASHINGTON,D.C.	JACKSONVILLE
Average Sales Price w/in Sample	($59,620.00)	($59,935.68)	($59,025.44)	($59,284.14)
MEANS:				
Title Assurance (1)	$101.14	$214.07	$266.66	$302.33
Conveyancing (2)	373.16	14.59	217.93	75.34
TOTAL	$474.30	$228.66	$484.59	$377.67
Standard Deviation	114.71	65.93	108.55	106.79

SMSA	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE
Average Sales Price w/in Sample	($60,359.95)	($59,568.74)	($59,690.29)	($59,473.26)
MEANS:				
Title Assurance (1)	$279.05	$357.74	$389.95	$281.91
Conveyancing (2)	279.85	23.92	115.71	110.12
TOTAL	$558.90	$381.66	$505.66	$392.03
Standard Deviation	213.88	59.21	59.99	173.95

(1) 'Title Assurance' includes fees identified on HUD-1 lines 1102, 1103 and 1108 as being for title search, title examination, and title insurance.

(2) 'Conveyancing' includes all other fees listed in the HUD-1 lines series, including settlement, document preparation, and attorneys fees.

SOURCE: 1979 HUD-1 Survey.

- The prices reflect the discounts that may be available with reissue rates for title insurance.

- A low amount spent for title assurance may actually be a reflection of customary practices within an area to forego an owner's policy, or not to show the additional premium on the HUD-1 settlement sheet.[1]

What the data reflect, then, are the average amounts paid for title assurance services, given the range of unique situations at each site.

What is important in these data is the wide range of charges consumers have paid for approximately the same services on the same price houses. The lowest average price for all services was in Denver, approximately $230, and the highest was in Los Angeles at $560. While both sites will be discussed in depth, it should be noted here that both are Western states with little or no attorney involvement in the title assurance process. The most important difference between the two states is the regulatory structure and the use of "escrow companies" in Los Angeles.

The differences in charges between other sets of cities is also interesting. For example, both the District of Columbia and St. Louis have only limited attorney involvement. Title insurance regulation is minimal and does not include rate regulation in either area. Yet D.C. charges are almost 25 percent higher than those in St. Louis. Further comparisons will be made after the presentation of the estimated prices and the individual site discussions. However, the HUD-1 data clearly show that home owners in this survey paid widely varying amounts for similar services in different areas.

The prices consumers pay can also vary within sites. Exhibit XII-5 indicates that the ratio of the standard deviation to the mean of the observations differs widely among sites. Bar charts of the distributions of the observations are presented with the discussion of the individual sites. Exhibit XII-5 indicates that charges for title and conveyancing services are most dispersed in Los Angeles and Seattle, and lease dispersed in St. Louis and San Antonio.

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[1] Interviews with providers and secondary sources indicated that the HUD-1 form frequently shows only the title insurance premium for a lenders policy; the additional cost for an owners policy is often omitted from the settlement sheet, since the provider may not know until closing whether an owners policy will be purchased. If the owners policy is desired, the purchaser pays the additional amount with a personal check and the amount is not reported on the HUD-1 form. Depending on the size of the loan, this amount may be substantial.

EXHIBIT XII-5

RATIO OF STANDARD DEVIATION TO MEAN

SITE	STD DEV/MEAN
Boston	24%
Denver	28
District of Columbia	22
Jacksonville	28
Los Angeles	38
St. Louis	15
Seattle	44
San Antonio	12

SOURCE: PMM&CO. Compilation from 1979 HUD-1 Survey

Estimated Pricing Data

In order to gain a thorough understanding of title and conveyancing markets in each SMSA, we compiled a second source of data. Estimates of title insurance and conveyancing services in each of the selected sample sites were developed from title assurance provider information. The estimated pricing data are presented in Exhibit XII-6.

These data were compiled from a variety of sources and structured to be consistent with data on the HUD-1; sources included:

- individual providers at the local level, and title insurance underwriters on the national level; and
- insurance commissions, bar associations and trade organizations.

The surveys and interviews provided us with reasonably detailed estimates of the prices for title and settlement services in each area. The estimates were calculated using some of the published price lists that were available, but also relying on quotations from industry sources as well as subjective evaluations of "typical" or "customary" charges.

In compiling estimates, we sought to obtain prices for complete title assurance protection for both the lender and the owner on a $60,000 house with a $50,000 mortgage; the price applied to the type of title assurance customarily used in that area. Prices were also obtained for all other customary title and conveyancing services. Providers were asked for usual prices, assuming that there were no abnormal or complicating factors involved in the transaction. These estimates were very carefully prepared, but they do not represent a full and complete accounting of the amounts actually paid by consumers. However, they do represent what a typical or average set of title insurance services would cost in each of the eight market areas. These data, which appear in Exhibit XII-7, should be used in conjunction with the HUD-1 cost estimates as well as with the information from interviews with experts and industry sources to analyze the pricing and market performance in the individual SMSAs.

Because practices, regulations and laws vary from one state to another, each site will be discussed individually to explain the level of prices appearing in Exhibits XII-4 and XII-6. However, it is evident that the relative price structures noted in the HUD-1 data remain the same. Denver is the lowest cost area and Los Angeles is the highest. It is also evident that these estimates are not significantly different from the HUD-1 averages, except in two cases, Jacksonville, Florida and Seattle, Washington. Since empirical data, such as the HUD-1's is affected by many sources of variation and error the relative closeness of the estimates and averages is, statistically speaking, a good indicator.

Individual Sites

Boston

The Boston title assurance and conveyancing market is unique among the SMSAs which were studied because title insurance is generally not used. The

EXHIBIT XII-6

ESTIMATED PRICING DATA – ALL SITES TITLE ASSURANCE & CONVEYANCING

For a $60,000 House With a $50,000 Loan

SMSA	BOSTON	DENVER	WASHINGTON, D.C.		
			VIRGINIA	MARYLAND	DISTRICT OF COLUMBIA
Title Assurance (1)	$ N.A. (3)	$261.00	$215.00	$212.50	$220.00
Conveyancing (2)	N.A. (3)	10.00	375.00	300.00	225.00
TOTAL	$500.00	$271.00	$590.00	$512.00	$445.00

SMSA	JACKSONVILLE	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE
Title Assurance (1)	$437.50	$348.00	$375.00	$391.00	$364.00
Conveyancing (2)	125.00	294.00	25.00	84.00	126.50
TOTAL	$562.50	$642.00	$400.00	$475.00	$490.50

(1) 'Title Assurance' includes all fees specifically quoted as being for title search, title examination, opinion of title and/or title insurance.

(2) 'Conveyancing' includes all other fees customarily paid for conveyancing services, including settlement, escrow, document preparation and attorneys fees.

(3) This subtotal breakdown is rarely defined in Boston, where attorneys generally provide all such services, without title insurance.

SOURCE: PMM&CO., 1980.

EXHIBIT XII-7

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR BOSTON, MASSACHUSETTS

	HUD-1 DATA	ESTIMATED PRICES	INTERVIEWS OF LOCAL ATTORNEYS (PMM&CO. SURVEY)
Title Assurance Fees	$101.14 (3)	$ N.A. (2)	$ N.A. (2)
Conveyancing Fees	373.16 (3)	N.A. (2)	N.A. (2)
Total Title Charges	$474.30	$500.00	$497.31
Standard Deviation			192.74

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

(2) A breakdown of total title charges into title assurance and conveyancing subtotals is generally not available in Boston. Since attorneys provide all services, any breakdown would be strictly arbitrary.

(3) The breakdown of HUD-1 pricing data only reflects those fees which have been formally identified for title assurance services on the settlement sheet.

SOURCE: 1979 HUD-1 Survey and PMM&CO. Attorney Survey, 1980.

predominant form of title assurance used is the attorney's opinion of title. When title insurance is purchased, it is purchased in addition to the title opinion. Boston area lending institutions have tended not to require the use of title insurance. They are able to accept the limited coverage of the attorney's title opinions because they generally do not sell their mortgages to secondary mortgage market sources that would require title insurance protection.

In this city, pricing data from the two primary sources can be effectively supplemented by data from interviews which PMM&Co. conducted with local attorneys. In those interviews, attorneys were asked for the average amount of their total fees in the sale of a $60,000 house. Exhibit XII-7 demonstrates the marked similarity of their responses to the pricing data from the other two sources. It is quite evident that the average price in Boston for title and conveyancing services on a $60,000 house is approximately $475 to $500. Exhibit XII-8 illustrates the distribution of title assurance and conveyancing charges.

There is no real indication that a typical consumer would be able to make an effective or informed choice of attorneys based on any shopping for prices. Attorneys in Boston, as in most areas, do not generally advertise their prices; nor do they typically provide an established price list for their services.[1] The few observations at the high and the low end of the distribution may represent special situations.

Some lenders in the Boston area specify the attorney to be used, and many others limit the number of "approved attorneys." The lender can also require that if a specific attorney is not used, then the papers will have to be "reviewed" by the specified attorney. Since the "review fee" may be high, any savings which could have been obtained through careful shopping will usually be nullified. More than 94 percent of the lenders interviewed in Boston acknowledged the use of such a "review fee" system.

Denver

The cost of title insurance and conveyancing services in Denver, as reflected in both the estimated and HUD-1 data, is the lowest among the sampled SMSAs. The difference between prices in Denver and in the other SMSAs are substantial. The prices are at least $150 less than those in any of the seven other sites. Given the magnitude of the difference, we have undertaken special efforts to affirm the accuracy of this pricing data, shown in Exhibit XII-9, and to determine the nature and characteristics of the market in the Denver area.

The predominant form of title assurance used in the Denver SMSA is title insurance, as it is in all of the eight sites except Boston. The rates for

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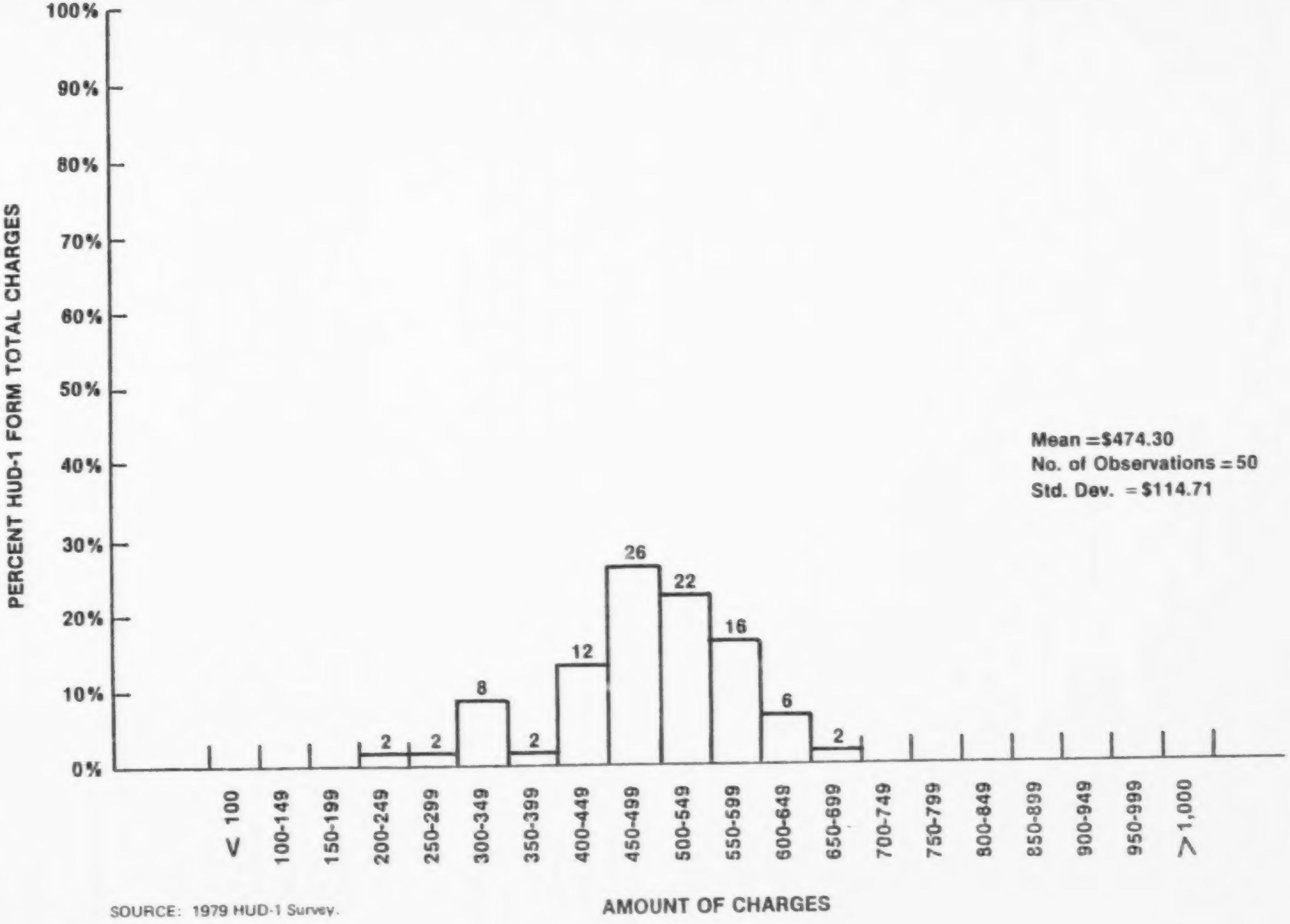
[1] In the attorney interviews in the eight sites, only one individual out of 91 actually advertised rates for real estate settlement.

EXHIBIT XII—8

BOSTON, MASSACHUSETTS
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



Mean = $474.30
No. of Observations = 50
Std. Dev. = $114.71

SOURCE: 1979 HUD-1 Survey.

EXHIBIT XII- 9

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR DENVER, COLORADO

	HUD-1 DATA	ESTIMATED PRICES
Title Assurance Fees	$214.07 (2)	$261.00
Conveyancing Fees	14.59 (3)	25.00
Total Title Charges	$228.66	$286.00

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

(2) Title insurance was purchased as the form of title assurance in 100% of the HUD-1 forms.

(3) Conveyancing fees were charged on only 40.0% of the HUD-1 forms.
The average amount charged in those cases was $36.48.

SOURCE: PMM&CO. and 1979 HUD-1 Survey.

title insurance are recommended by a rating bureau, and those rates are approved by the state insurance commission.[1] It is treated as an "all-inclusive" rate, and a separate fee may not be charged for the title search. The rate for an owners policy for a $60,000 house is $241, and the accompanying simultaneous issue fee is $20. The price of a lenders policy only is $217 for a $50,000 loan. The fact that the HUD-1 data show an average expenditure for title services of $214.07 may be the result of a practice of not showing the additional amount necessary to purchase an owners policy.[2] It may also be a result of the availability and use of reissue rates, which cause the title insurance premium to be reduced by 50 percent if a policy on the same property has been issued within the last two years.

All providers in the real estate industry are permitted to supply conveyancing services in Denver. The Colorado courts have refused to extend unauthorized practice of law prohibitions to restrain lenders, brokers, or title companies from preparing routine real estate documents, conducting settlements, or performing escrow functions. The role of the attorney in the real estate settlement market is generally limited to advice and assistance in contract negotiation and special situations.

The principal significance of the Denver conveyancing market is the comparatively low fees charged for these services. Often nothing is charged for settlement, escrow, and document preparation. Fees for conveyancing services are charged on only 40 percent of the sampled HUD-1 forms. This indicates that in 60 percent of the sampled transactions, the only fee for title or conveyancing services was the premium for title insurance. In those cases in which a conveyancing fee was charged, the amount of the fee averaged only $36.48. Exhibit XII10 indicates that Denver has a bimodal distribution, with 47 percent of the observations between 150 and 200 and 29 percent between 250 and 300. The ratio of the standard deviation to the mean in Denver, 28 percent, was not as low as might be expected given the rate structure.

Interviews with the Colorado State Insurance Commissioner, as well as with numerous local providers, indicated that the settlement market in Denver is

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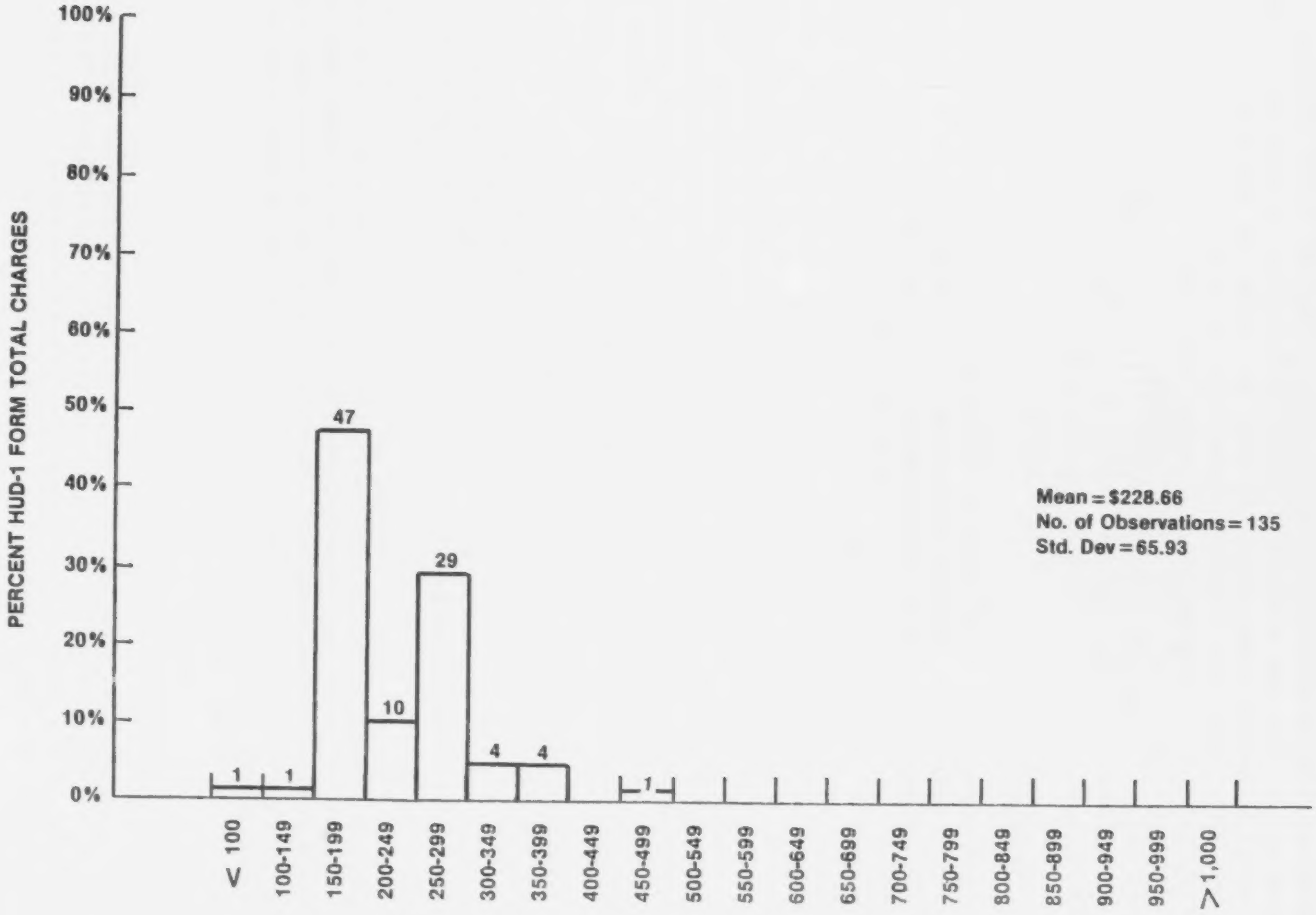
[1] This process recently underwent a legal challenge in the Colorado courts. The largest title company had refused to accept a price increase recommended by the rating bureau. The company stated that the increase was unnecessary and did not change its prices. Since this company already had a 50 percent market share, the remainder of the market providers did not proceed with the planned increase.

[2] It should be noted that the average amount shown on the HUD-1 forms as the premium for title insurance was only $211.65. There was usually an additional charge of $15.00 listed on 16.3 percent of the settlement sheets as being for "title examination." This raised the average for all title assurance services to $214.07.

EXHIBIT XII— 10

DENVER, COLORADO
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



Mean = $228.66
No. of Observations = 135
Std. Dev = 65.93

SOURCE: 1979 HUD-1 Survey.

characterized by a very real rivalry for the primary services offered by lenders, brokers, and title companies. This rivalry appears to have taken the form of supplying conveyancing services at a nominal cost. However, this situation is not the result of either pure competition or open price competion for title assurance services. The rate for title insurance is regulated and remains at a fixed rate despite substantial efforts, both in and out of the courts, to have it raised. On the other hand, the low prices cannot be attributed to the regulatory environment in Denver, which is not unique. Many places have a regulated "all-inclusive" title insurance rate and unregulated prices for conveyancing services. The low prices have been attributed principally to the customary practices in the area.

Washington, D.C.

The Washington, D.C., SMSA is divided into three distinct jurisdictions, each with different characteristics. There is considerable difference in the use of attorneys and title companies for the title search and conveyancing functions. Although geographical proximity results in a mixing of local practices in the District of Columbia, the title companies tend to peform most of the mentioned services, while in Maryland and Virginia attorneys are the principal providers. Virginia, in fact, was unique in its UPOL regulation, in prohibiting anyone from conducting a title search unless they are a licensed attorney or are under the direct supervision of a licensed attorney. In Maryland, the practice of a lender's requiring a legal review by his own selected attorney is commonly used to effectively mandate the use of a particular attorney. As a result of this variation in the use of different providers, the prices for the title search and conveyancing services differ widely, both by political jurisdiction and by individual providers.

Exhibit XII-11 presents the pricing data from all of our sources in the Washington, D.C., SMSA. Since the HUD-1 data were limited to the District of Columbia, the estimated pricing data for Virginia and Maryland are particularly important. The prices for the title insurance premiums are basically identical in each of the areas because almost all of the title companies use the so-called "national rate" to calculate the premium.[1] The rate is not regulated, nor has it been officially adopted by any of the regulatory agencies, but it is generally used by all of the providers of title insurance in the Washington, D.C. area. It is not an "all-inclusive" rate, and it is sometimes identified as the so-called "risk premium." There is little indication that reissue rates are used on a regular basis, although they may be available in some circumstances.

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[1] The "national rate" was described earlier in this chapter. Although the rate is used in many areas, it is not an officially adopted rate. The phrase "national rate," however, is generally used in the industry to identify this very common pricing schedule for risk or indemnity insurance.

EXHIBIT XII- 11

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR WASHINGTON, D.C.

	ESTIMATED PRICES			HUD-1 DATA
	VIRGINIA	MARYLAND	DISTRICT	DISTRICT
Title Assurance Fees (2)	$215.00	$212.50	$220.00	$266.66
Conveyancing Fees	375.00 (3)	300.00 (3)	225.00 (4)	217.93 (4)
Total Title Charges	$590.00	$512.50	$445.00	$484.59

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

(2) In almost all cases, the title assurance fees were identified as the fairly standard rate for the title insurance premium.

(3) In Virginia and Maryland, where attorneys are heavily involved, the attorneys fees were not broken down to identify any title search fee.

(4) In the District of Columbia, where title companies are a principal provider, the conveyancing fees are usually identified as a 'settlement fee' without being further broken down.

SOURCE: PMM&CO., 1980 and 1979 HUD-1 Survey.

Considerable variation is evident, however, in the prices charged for all of the fees other than title insurance. It can be noted, that the fees charged in the District of Columbia are generally lower than in the surrounding suburbs. In fact, the estimated charges in Virginia are 30 percent higher than those in the District. In Maryland, both title insurance companies and attorneys are allowed to provide title assurance and conveyancing services. The estimates presented here are from attorney providers because this process is most common. If title insurance companies are used, the estimated cost is approximately $100 lower.

The distribution presented in Exhibit XII-12 is for the District of Columbia. Our interviews indicated that in the District, the difference in price from title insurance companies for the same package of services ranged from $38.00 on a $60,000 house to $70.00 on a $125,000 house. Exhibit XII-12 shows the real range to be larger, with approximately 20 percent of all observations over $600 and 7 percent less than $300. The ratio of the standard deviation to the mean was 22 percent. Thus, it appears that prices vary not only among political jurisdictions but among companies also.

Jacksonville

The title insurance and conveyancing market in Jacksonville is representative of many areas of the United States which are experiencing changes in patterns of customary title and conveyancing practices. In many parts of Florida, the principal providers of these services are the attorneys. In other parts of Florida, the title companies have begun to supplant the role of attorneys in comparatively routine functions. Jacksonville is in the midst of such a change.

The Florida State Insurance Commission has established a promulgated rate for title insurance which is a minimum below which a title company's premiums may not fall.[1] The promulgated rate is the so-called "national risk rate" which is used in many areas. The title insurance rates which are actually published and used by title companies in Jacksonville are considerably higher since they include a search fee. The promulgated or national rate for an owners policy for a $60,000 house is $205.00, but the rate which is published and quoted by almost every title company in Jacksonville is $412.50. Additional fees for attorneys would be about $125.00 according to our interviews.

These estimates differed considerably from the pricing data compiled from the information shown on the HUD-1 forms, as shown in Exhibit XII-13. There can be a number of reasons for this difference. Our interviews suggested that considerable negotiation is possible in Jacksonville for lower rates on most conveyancing and title assurance services. This could explain some of the

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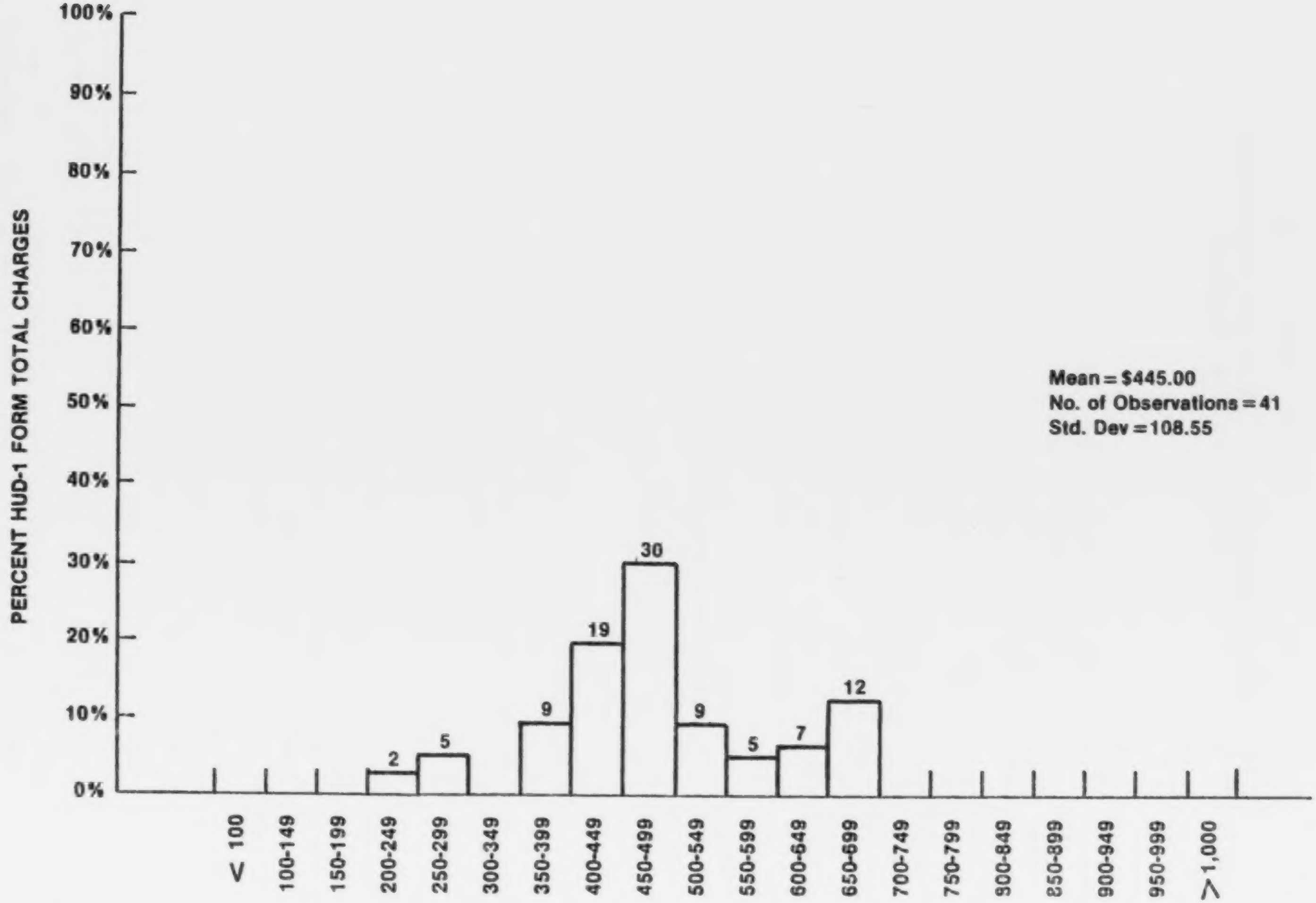
[1] The rationale for a minimum rather than a maximum rate is that the insurance commission has used the promulgated rate to address its obligation to assure that the title insurance companies will remain solvent.

EXHIBIT XII— 12

DISTRICT OF COLUMBIA
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



Mean = $445.00
No. of Observations = 41
Std. Dev = 108.55

SOURCE: 1979 HUD-1 Survey.

EXHIBIT XII-13

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR JACKSONVILLE, FLORIDA

	HUD-1 DATA	ESTIMATED PRICES
Title Assurance Fees	$302.33	$437.50
Conveyancing Fees	75.34	125.00
Total Title Charges	$377.67	$562.50

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

SOURCE: PMM&CO., 1980 and 1979 HUD-1 Survey.

variation. However, the distribution shown in Exhibit XII-14 is not skewed upwards as one would expect, if this hypothesis were true. The distribution is wider, however, than that in places such as Denver, where almost 50 percent of the observations were within a $50 range.

Los Angeles

The total cost of title assurance and conveyancing services in the Los Angeles area was the highest among the eight selected sample sites. Title insurance is used almost exclusively as the acceptable form of title assurance, but an unusual feature of the title and conveyancing market in Los Angeles is the use of escrow companies to provide the conveyancing services. While the title companies supply the title searches, examinations, and insurance at rates which are not unusually high, the conveyancing functions are then performed by escrow companies who charge substantial fees. Escrow companies may be independent but often are owned by real estate brokers, lenders, or title companies. The estimated prices in Exhibit XII-15 were obtained entirely from title insurance companies, which perform the entire package of title assurance and conveyancing services.

The provision of conveyancing services by different types of providers probably accounts for the wide disparity of prices in Los Angeles. Exhibit XII-16 shows that prices vary substantially and that there is no central tendency such as exists elsewhere. The standard deviation in Los Angeles was $214, while the mean was $558.90.

Another source of variation unique to Los Angeles is the use of a California Land Title Association policy as the standard form of a lenders policy. An additional fee is charged if the bank requires, as they frequently do, lenders title insurance using an American Land Title Association (ALTA) policy. The differences between the policies are apparently sufficient to prompt most secondary mortgage market investors to request the ALTA form.

The Los Angeles SMSA is the national model for open and unregulated competition in the markets for title assurance and conveyancing services. There is effectively no regulation of rates, either for title insurance or for any of the other services covered by this chapter.[1] While open competition may not be a cause of high prices, neither has it promoted rate competition and consumer savings.

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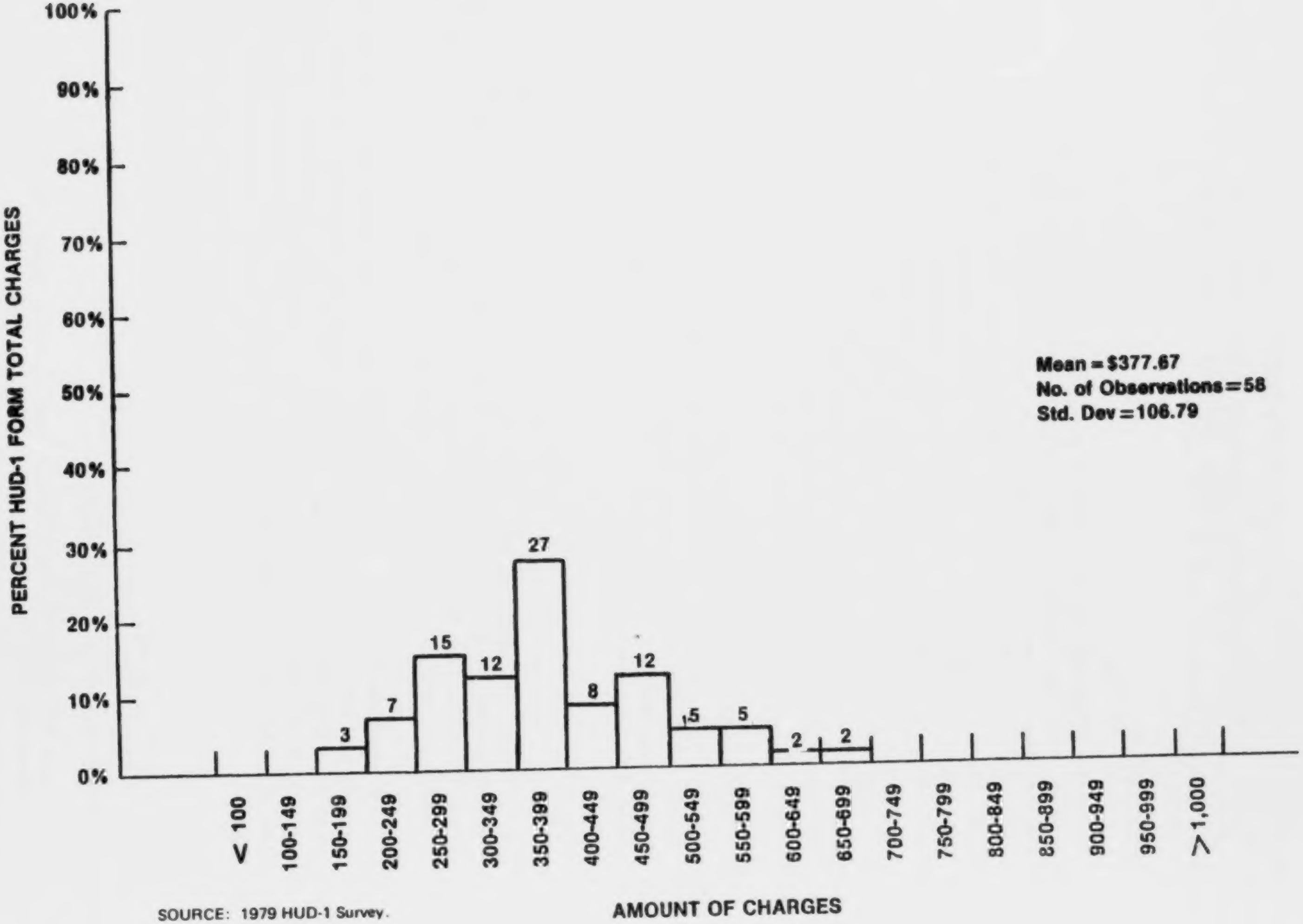
[1] The regulation of title insurance in California does, however, attempt to prohibit undesired practices in considerable detail, even to the extent of legislating the amount a salesman can spend on lunch for a customer.

EXHIBIT XII—14

JACKSONVILLE, FLORIDA
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



Mean = $377.67
No. of Observations = 58
Std. Dev = 106.79

SOURCE: 1979 HUD-1 Survey.

EXHIBIT XII- 15

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR LOS ANGELES, CALIFORNIA

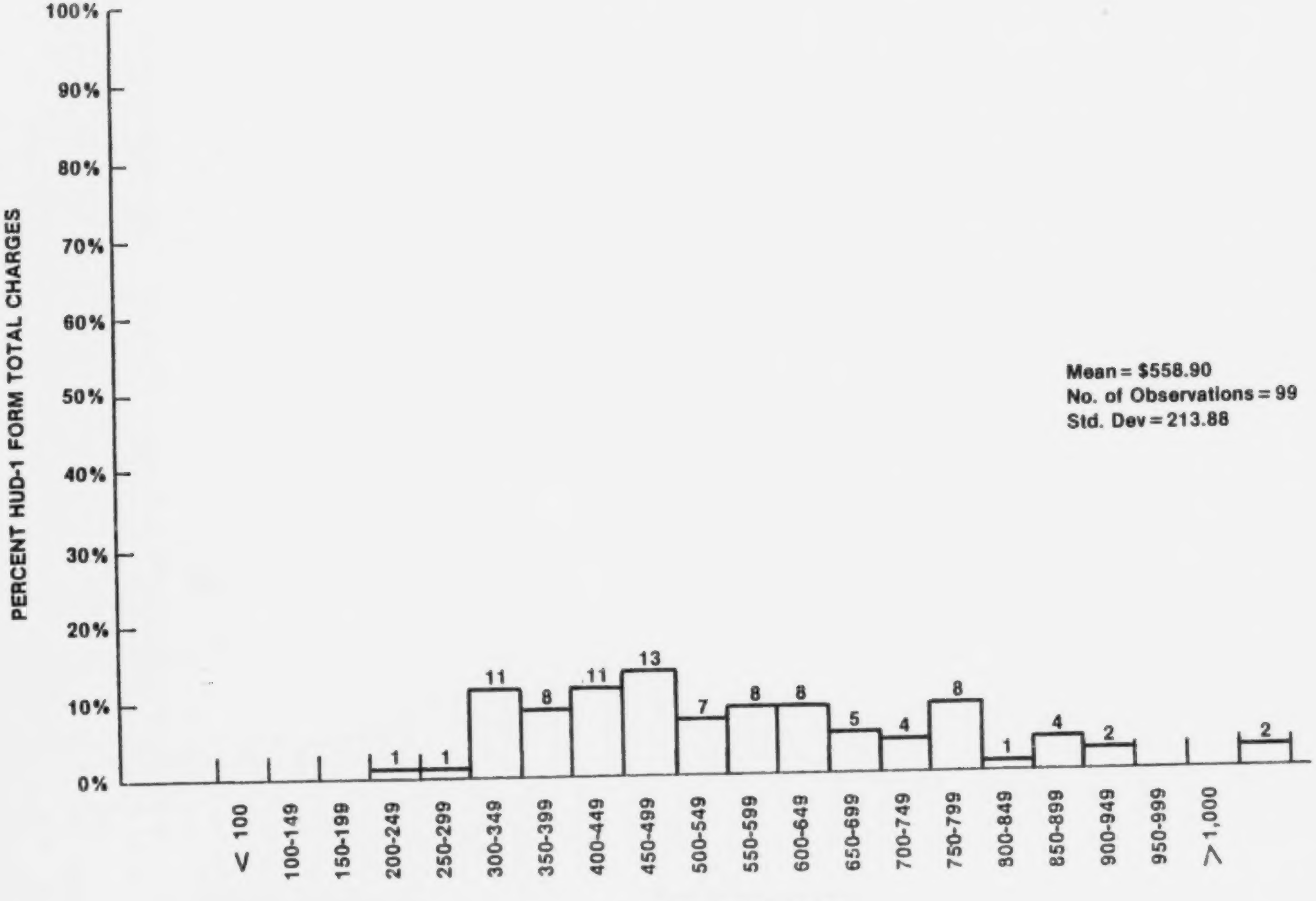
	HUD-1 DATA	ESTIMATED PRICES
Title Assurance Fees	$279.05	$348.00
Conveyancing Fees	279.85	294.00
Total Title Charges	$558.90	$642.00

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

SOURCE: PMM&CO, 1980 and 1979 HUD-1 Survey.

EXHIBIT XII—16

LOS ANGELES, CALIFORNIA
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



Mean = $558.90
No. of Observations = 99
Std. Dev = 213.88

SOURCE: 1979 HUD-1 Survey.

St. Louis

In Missouri, the state insurance commission has the power to assure fair and equitable title insurance rates. However, a court injunction has restrained the collection of any rate data for several years. Interviews with personnel at the insurance commission indicated little concern for the regulation of title insurance. Thus the relatively low rates which are charged are not the result of rate regulation.

There is little attorney involvement in real estate transfers in Missouri, according to our interviews. The title insurance companies usually provide not only title assurance but also conveyancing services. The fees quoted in Exhibit XII-17 are all-inclusive. For this reason, the charges for title assurance may appear high. However, often no extra charges are made for conveyancing.

The uniformity, as well as relatively low levels of rates in St. Louis (see Exhibit XII-18) can only be explained as historical and customary practice. The standard deviation was only 15 percent as large as the mean. This ratio was larger in all other sites except San Antonio. There are no unusual circumstances that we could identify which would lead to this type of pricing structure.

San Antonio

The prices for title assurance and conveyancing services in San Antonio demonstrate the problems of an all-inclusive regulated rate which is not, in fact, all-inclusive. Title companies provide not only title assurance in San Antonio, but most of the conveyancing services as well, including settlement and escrow functions. However, unauthorized practice of law regulation in Texas requires that attorneys prepare the necessary transfer and loan documents. This proves to be a critical factor since the average amount charged by attorneys in San Antonio, on the surveyed HUD-1 forms, was $85.24. It is important to note that the role of attorneys in San Antonio in routine title and conveyancing services is strictly limited to the preparation of documents and is protected by the UPOL regulation.

It is also important to note that while settlement is considered to be included in the all-inclusive regulated rate for title insurance, the charge for handling for escrow are not. As a consequence, title companies regularly charge an escrow fee in addition to the premium for title insurance. The average fee identified for escrow was $28.39. The combination of escrow fees and document preparation fees increased the average total cost for title services by $113.63 over the regulated rate. As is shown in Exhibit XII-19 and XII-20, consumers pay considerably more than the fee which the insurance commission sets. The additional fees do not appear to vary considerably. The ratio of the standard deviation to the mean was the lowest of any of the sites. Forty percent of the observations were between $450 and $500.

EXHIBIT XII- 17

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR ST. LOUIS, MISSOURI

	HUD-1 DATA	ESTIMATED PRICES
Title Assurance Fees	$357.74 (2)	$375.00
Conveyancing Fees	23.92 (3)	50.00
Total Title Charges	$381.66	$425.00

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

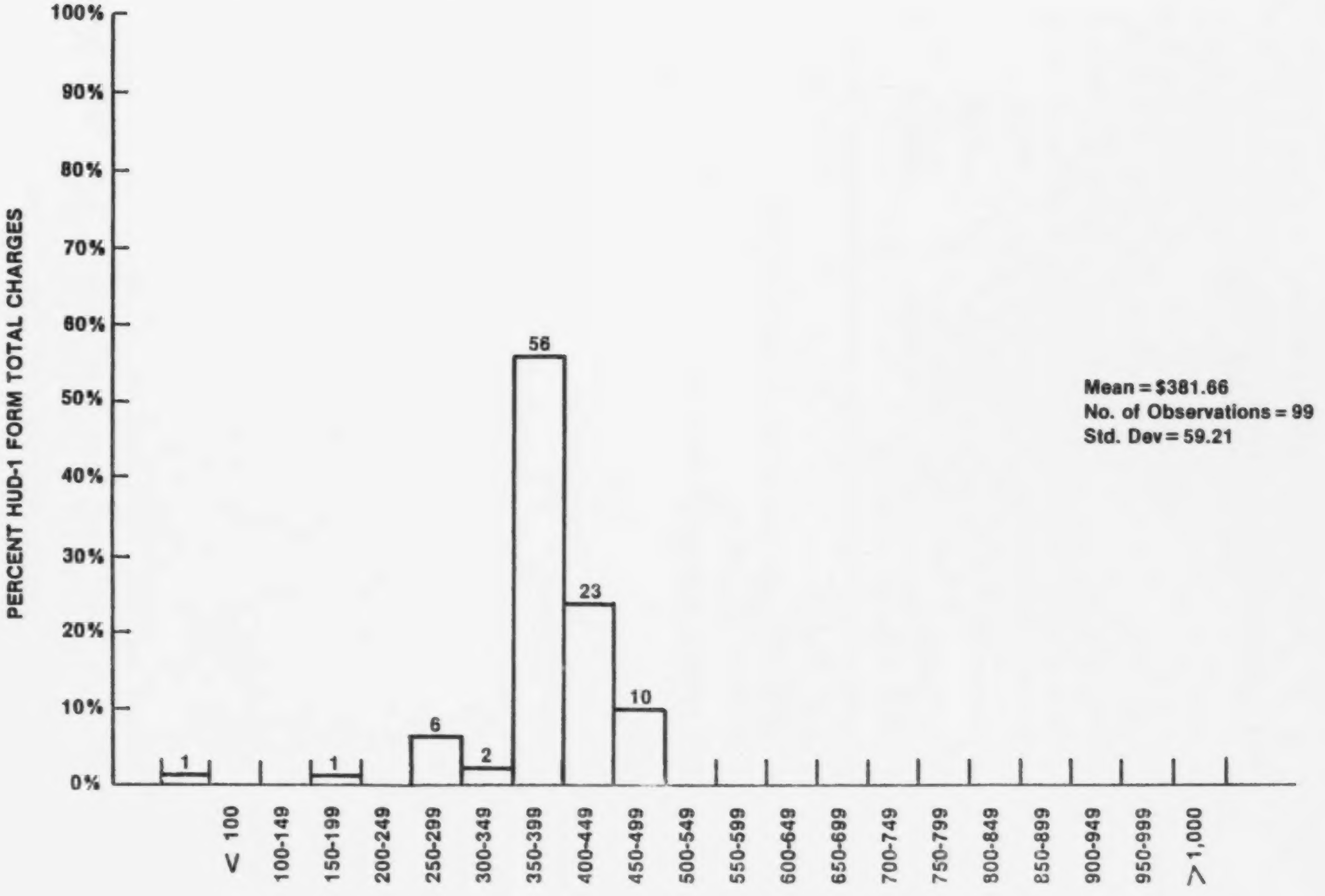
(2) Title insurance was purchased as the form of title assurance in 99% of the HUD-1 forms.

(3) Conveyancing fees were charged on only 52.5% of the HUD-1 forms.
The average amount charged in those cases was $45.54.

SOURCE: PMM&CO., 1980 and 1979 HUD-1 Survey.

EXHIBIT XII—18

ST. LOUIS, MISSOURI
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



SOURCE: 1979 HUD-1 Survey.

EXHIBIT XII-19

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR SAN ANTONIO, TEXAS

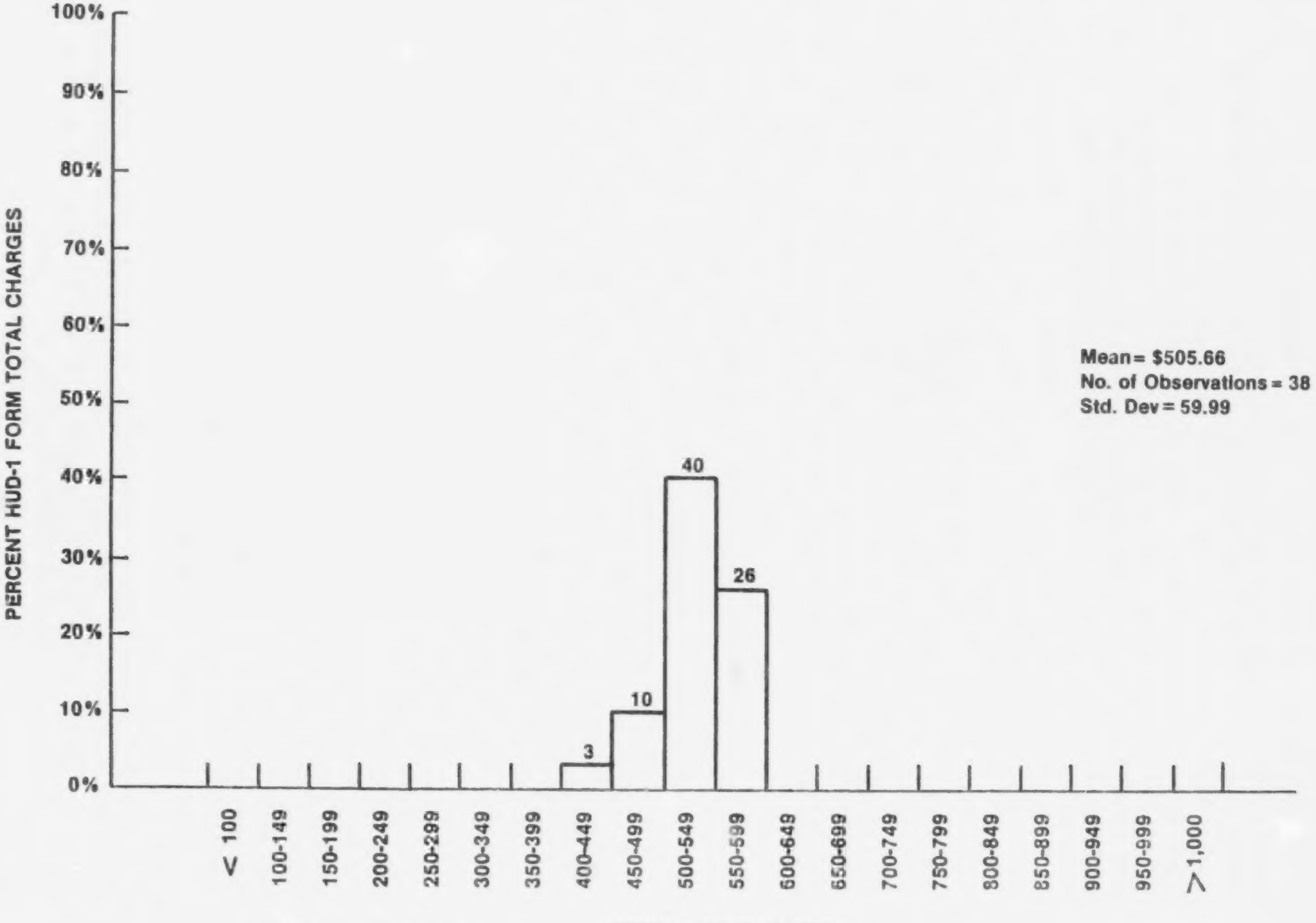
	HUD-1 DATA	ESTIMATED PRICES
Title Assurance Fees	$389.95	$391.00
Conveyancing Fees	115.71	84.00
Total Title Charges	$505.66	$475.00

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

SOURCE: PMM&CO., 1980 and 1979 HUD-1 Survey

EXHIBIT XII— 20

SAN ANTONIO, TEXAS
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



SOURCE: 1979 HUD-1 Survey.

The effect of these extra fees is important because the Texas Insurance Commission has taken an especially active role in establishing and regulating rates for title insurance. Of the eight sites, only in Texas does the insurance commission hold annual formal hearings with complete adversarial proceedings to determine and set a single, all-inclusive rate. The HUD-1 data suggest that this established rate is frequently used. Variation in the HUD-1 data for the insurance rate is relatively low and can be explained entirely by the infrequent choice not to purchase owners title insurance. There is no reissue rate available in Texas.

Seattle

The Seattle market for title and conveyancing services provides a unique situation in which escrow companies are regularly used to supply conveyancing services for a substantial escrow fee while at the same time many lenders regularly provide the same services without charging an additional fee. The result is that some consumers pay fees at the same level as those in Los Angeles, while others pay an amount not substantially higher than in Denver. Exhibits XII-21 and XII-22 demonstrate this very unusual situation.

The rates for title insurance in Seattle are fairly standardized. An owners policy for a $60,000 house is usually $264.00, plus sales tax, and the ALTA lenders policy generally costs an additional $80.00 to $90.00, plus tax. In practice, the amount actually paid for title insurance, subject to reissue rate discounts, etc., was $281.91. The HUD-1 data show that in almost half of the transactions, 57.1 percent, the provider of settlement or escrow services did not charge any additional fees for those services. The bar chart in Exhibit XII-22 shows wide dispersion in charges. In 20 percent of the cases, charges were less than $250; in 15 percent they were $600 or more. The standard deviation is 44 percent as large as the mean. This is the largest relative deviation in any of the eight sites.

Interviews with local providers indicated that many lenders do, in fact, supply these services without additional charge. In the other half of the transactions, however, our interviews indicate that the escrow companies performed these functions. The average price quoted by escrow companies in our surveys and interviews and listed on published price lists was $253.00. Clearly, if a home buyer is knowledgeable, he will shop for a lender who provides conveyancing services. The continued existence of escrow companies and their additional fees demonstrate that many home owners are poorly informed and do not engage in such shopping.

Another unique characteristic of the provision of settlement services pricing in Seattle is the title insurance regulation requiring any title insurance company conducting searches in Seattle to maintain a full and complete title plant. This regulation has acted as a severe barrier to entry, and title insurance in Seattle is provided by only six title companies. That is the smallest number in the eight selected sample sites. The effect of this limited number of title insurance providers is not clear, especially in light of the

EXHIBIT XII-21

TITLE ASSURANCE AND CONVEYANCING PRICING DATA (1) FOR SEATTLE, WASHINGTON

	HUD-1 DATA	ESTIMATED PRICES
Title Assurance Fees [1,2]	$289.91	$364.00
Conveyancing Fees [3]	110.12	253.00
Total Title Charges	$392.03	$617.00
Standard Deviation	173.95	

(1) The criteria for comparison are detailed in Exhibits XII-4 and XII-6.

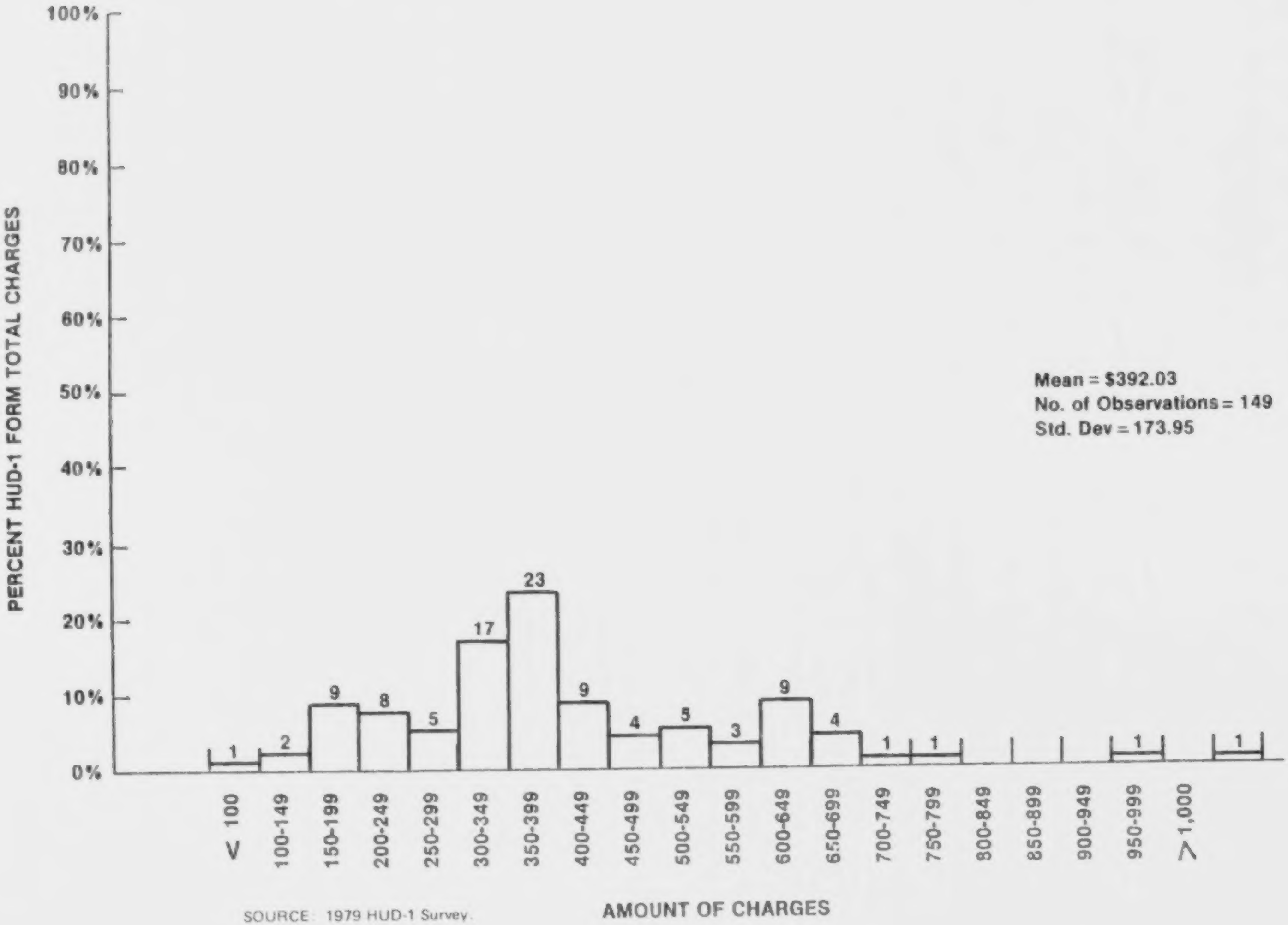
(2) Title insurance was purchased as the form of title assurance in 99% of the HUD-1 forms.

(3) Conveyancing fees were charged on only 48.3% of the HUD-1 forms. The average amount charged in those cases was $227.90.

SOURCE: PMM&CO., 1980 and 1979 HUD-1 Survey.

EXHIBIT XII— 22

SEATTLE, WASHINGTON
DISTRIBUTION OF TOTAL TITLE ASSURANCE AND CONVEYANCING CHARGES



Mean = $392.03
No. of Observations = 149
Std. Dev = 173.95

SOURCE: 1979 HUD-1 Survey.

unique situation in the conveyancing market. It can be noted, however, that many of the major escrow companies are affiliated with the title companies, just as they are in Los Angeles.

Summary

Data from the eight sites indicate that numerous regulations and practices make the purchasing and selling of title insurance appear quite different from one area to the next. The same product is being sold, but the characteristics of the market make the process seem quite different.

Clearly prices vary significantly from one area to the next. Even if Los Angeles and Denver are viewed as special cases, other sites vary for no apparent economic reason. Charges by title insurance companies in the D.C. area are 25 percent higher than prices by these same companies in St. Louis. While charges in Boston are apparently low, they do not include title insurance. Consumers are not receiving the same package of services that they do elsewhere, although it is doubtful that in New England expected losses are higher because of attorney opinions either to attorneys or home buyers, than those in other areas. Further, within the Washington, D.C. area, SMSA charges are significantly higher in Virginia than in the District. The previous discussion clearly implies that the practices and price structures in each area are determined more by historical chance or by local institutional factors than by an economic rationale. Clearly the implication of such a finding is that classical economic solutions to noncompetitive market environments will not lower prices. For example, there is little indication that increasing the number of entrants into the market will lower prices. There may be little incentive for market participants to be innovative with pricing.

Further, the type of rate regulation in a given state does not seem to determine the level of prices. The major importance of rate regulation in the pricing of title and conveyancing services lies in its potential to control the undesirable effects of reverse competition on prices. Some of the state insurance commissions have recognized this potential to address the problems of high prices and extraordinary abuses in the title insurance and conveyancing industries. In our sample, Colorado and Texas were the only states to set rates. Other state insurance commissions, such as in Missouri, Florida, Maryland and D.C., have decided that their proper role is simply to assure that the insurance companies remain solvent.

The insurance commissions that have tried to realize the full potential of rate regulation have met with mixed success. There is no indication that each of the efforts to regulate the premiums for title insurance and title search has lowered total charges. Some of these efforts have succeeded, while others have not. The success of rate regulation is substantially affected by the inclusiveness of the rate as well as the levels at which rates are set. The inclusiveness of a regulated rate is most frequently a function of local perceptions and customary practices. This is demonstrated by the examples of Denver and San Antonio.

There is every indication that the Texas commission has assumed a much more active role in the regulatory efforts than has the Colorado commission, and there is no doubt that the title companies in Texas are adhering to the established price schedules. The higher prices in San Antonio may be partially due to the existence of unauthorized practice of law protections for the preparation of documents by attorneys. They are certainly affected by the fact that the set rate in Texas is almost 50 percent higher than it is in Colorado.

It can be noted that regulated, all-inclusive rates have had a substantial impact on reducing the wide variability of prices within a market. With the price of title assurance set, the only sources of variation are the fees for services not included, the availability of a reissue rate, and the consumer's own choice on the purchase of an owners policy. Similarly, rate regulation has substantially decreased the possibility for extraordinaty pricing abuses. It is also probable that more effective rate regulation is possible if the commissions had more information available.

A conclusion must be reached, given all the pricing information available to us, that workable completition does not exist in the title insurance industry. If price competition was widespread, the variation in price levels between sites would be very small and insurance commission price regulation would be important to lowering prices. In the next section, the relationship of industry costs to pricing will be discussed. These costs would have to vary significantly by site to justify the large variation in consumer prices. However, at this point, it would appear that prices in each area depend more on the development of the industry within each particular locale, than on price or workable competition.

STATE TITLE COSTS

In addition to the HUD-1 data on SMSAs, HUD-1 forms for all fifty states were obtained in this study. HUD-1's from the eight relevant SMSA sites is not included in the state data. Table 1 presents the average total title charges for all fifty states for houses priced between \$45,000 and \$50,000.[1]

It is difficult to draw any conclusions from this data. The number of observations in some of the groups was very small. It can be seen that most title charges fall between \$300 and \$500. This represents almost 60 percent difference without accounting for the highest and lowest state. This confirms our findings in the eight sites of a large variation in title assurance and conveyancing service charges.

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[1] These data are reproduced from Chapter XIII. The \$45,000-\$50,000 range does not correspond to the range used previously in this chapter.

TABLE 1

AVERAGE TOTAL TITLE CHARGES BY STATE FOR HOUSE SALE PRICES OF $45,000 – $50,000 (1)

STATE	AVERAGE TOTAL TITLE CHARGES	STATE	AVERAGE TOTAL TITLE CHARGES
1 Alabama	405	26 Montana	271
2 Alaska	448	27 Nebraska	142
3 Arizona	441	28 Nevada	353
4 Arkansas	236	29 New Hampshire	244
5 California	703	30 New Jersey	699
6 Colorado	221	31 New Mexico	379
7 Connecticut	600	32 New York	507
8 Delaware	609	33 North Carolina	430
9 Florida	762	34 North Dakota	143
10 Georgia	424	35 Ohio	369
11 Hawaii	564	36 Oklahoma	340
12 Idaho	321	37 Oregon	375
13 Illinois	335	38 Pennsylvania	557
14 Indiana	290	39 Rhode Island	413
15 Iowa	210	40 South Carolina	505
16 Kansas	281	41 South Dakota	192
17 Kentucky	181	42 Tennessee	446
18 Louisiana	480	43 Texas	495
19 Maine	247	44 Utah	319
20 Maryland	493	45 Vermont	269
21 Massachusetts	459	46 Virginia	468
22 Michigan	325	47 Washington	413
23 Minnesota	317	48 West Virginia	321
24 Mississippi	550	49 Wisconsin	264
25 Missouri	307	50 Wyoming	210

SOURCE: 1971 HUD-1 Survey.

(1) Total Title charges includes title insurance, title search and examination, and all of the conveyancing services which include settlement and escrow charges and document preparation (all items in the 1100 series on the HUD–1 form)

PRICES AND COSTS

The pricing data just discussed show that the level of prices consumers pay to receive title assurance and conveyancing services varies substantially among locations and often within the same area. It is important, however, to examine the pricing structures and the general level of prices with respect to the costs incurred by the provider industries. Precise data on all costs are not available. However, this section will discuss the major types of costs that title assurance providers incur and the relationship to prices.

The major question asked at the beginning of the last section was whether workable competition exists. An additional question is whether the market is performing well in terms of providing services to consumers at the lowest possible cost. In a well functioning market for a uniform product or service, prices should approximate the cost of efficiently providing that product or service, including some normal rate of return. If prices vary substantially from one area to the other with no variation in cost, this would indicate poorly functioning markets. For this reason costs must be analyzed to see if they vary extensively over geographic areas.

Costs of Providing Title Assurance

Costs involved in providing title assurance include losses and search costs. Each of these is discussed below.

Losses

The title insurance industry characterizes its role as that of a "risk-avoidance" rather than a "risk-acceptance" insurance industry. This position is explained as resulting from the consumer's need to have the exact condition of title and an assurance that the determination of title was accurate. Thus, the title insurance underwriter arranges for a title search and evaluation which, theoretically, should reveal any defects in title as well as any liens or taxes that affect the property. If any such problems are discovered, the problem must be eliminated or excluded from coverage, or the insurance company will not insure the title. This type of risk avoidance limits the liability of the title insurance company to losses resulting from some off-record risks, as were described in Chapter V, and from their own failure to find all recorded title defects.

The claims data available from title insurance industry sources report that losses are generally below 10 percent of premiums, significantly lower than those that characterize other insurance lines. However, these loss ratios are somewhat ambiguous. The calculations using nation-wide data are according to our interviews, computed from data reported on Form-9s to the insurance commissioners. The term "losses" includes both claims paid and the cost of litigating claims. The ratio is computed using total operating income. This includes fees for risk insurance, searches and examinations, surveys, agency and escrow fees, and miscellaneous. It does not include investment income, but if it did, the ratio would be even lower.

Depending on the business arrangements of a particular firm and area, different premiums will be reported. For example, in states where title insurance companies perform the search and conveyancing services, all of the income from these functions will be reported. In cases where attorney-agents are used, the search and conveyancing fees may not be remitted to the underwriter. The figures reported on the Form-9 are the portion of the risk premium sent to the company. In other cases, the entire risk premium is reported and the commission is deducted as an expense. Because the income reported depends on the primary provider, the loss ratios developed by the industry cannot be defined. To put loss ratios in perspective, however, losses as a percentage of total title assurance charges (including search) can be expected to be in the 5 to 10 percent range; losses as a percentage of title insurance premiums (including agent commissions and retentions, but excluding search fees) can be expected to be in the 5 to 15 percent range; and losses as a percentage of premiums less commissions and retentions can be expected to be in the 10 to 20 percent range. All of these figures are low compared to other lines of insurance.

While no exact data are available on what risks account for the largest portion of losses, our interviews indicated that of the total amount paid for losses the vast majority went for tax and mechanics liens. Cases of a total failure of title, where someone other than the insured owner has a substantial interest in the property, are very rare. Most claims occur on new homes. The mechanics liens are from workers and subcontractors who were not paid by builders.[1] These types of liens are paid only if they are on record at the time of the purchase and overlooked in the title searching process. In some states mechanics liens may be filed up to six months after the work has been completed. These liens are not the responsibility of the title insurers under a standard ALTA owners policy.[2] The findings indicate that basing the price of title assurance on the price of the house is artificial. Certainly, the incremental pricing gradations for title insurance premiums are not related to actuarial claims experience, since the losses paid for taxes and mechanics liens are also generally unrelated to house price.

When discussing losses and loss ratios, it is essential to keep the magnitude of the losses in the proper perspective. Even extraordinarily high losses do not represent a substantial portion of total revenue, no matter how revenue is defined. Losses are simply not a meaningful factor when the costs of producing title assurance services are analyzed.

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[1] While this occurence is possible on used homes where additions or other work has been recently completed, it is rare.

[2] They are the responsibility of the insurer under the lenders policy, but only if the amount due is more than the down payment on the house.

Search Costs

There seems little doubt that the largest cost component of title assurance is the search for problems in the history of the title ownership and present liens against the property. In many areas this function is still labor intensive. Title company and law firm employees search through the public records for the necessary title information. In most urban areas, however, title plants owned by each title company or by a consortium of title companies provide information with significant savings of labor and time. Daily updates of all the information recorded in the public files each day are indexed in the title plant for quick and easy access. Thus the history of a given property can be evaluated on short notice, supposedly at a lower cost than if the public records were searched manually. The most sophisticated plants are computerized. Title plants are used extensively in all of the eight selected sample sites except Boston. In San Antonio and Seattle they are required by law. The computerized plants are common in Los Angeles.

We could not obtain adequate information on title-plant capital and operating costs to determine their relative economic efficiency. The pricing data compiled in this study suggests that sophisticated title information systems do not necessarily translate into price savings for the consumer, as demonstrated by the fact that Los Angeles had the highest cost of any of the sites. However, the high prices were identified not with the search and insurance functions, but with extremely high escrow fees charged even by the title insurance companies. This is a clear indication that purely economic considerations such as production costs do not determine charges in these industries.

One common misconception is that search costs differ substantially from one state to another due to varying real property laws. Although the laws do, in fact, differ quite a bit, the processes and techniques of title searching are quite similar. It is realistic to assume that with the widespread use of the title-plant process, variations in costs and charges should tend to diminish. The pricing data presented earlier in this Chapter do not indicate such a convergence. Thus, there is considerable question as to whether the efficiencies of technology used by title insurers are being reflected in the price to the consumer. In many areas, rate structures have not changed in many years. Revenues have increased as house prices and population mobility increase, but the amount charged for a given house has remained constant. In a competitive industry, cost savings would be expected to be reflected in reduced overall schedules.

Finally, in many areas, especially where all-inclusive rates are not used, the charges for the search, like insurance, are based on the price of the house. While exact cost figures for conducting a search are not available, clearly they are unrelated to the price of the house. The pricing structure used, according to most industry sources, is based on history, local custom and tradition. There is no indication that it is based on costs, economic rationale, or even profitability.

Distribution of Excess Revenue

The evidence presented in the pricing section suggests that the total cost of title assurance varies from one area to the next by as much as 100 percent. However, since loss ratios and search costs tend not to vary substantially, in at least some areas high prices suggest high profits. If the four conditions for pure competition were all met, these excess profits would be temporary, and as providers compete for customers, both levels of profits and prices would decline. In fact, the dominant economic characteristic of the title insurance industry is reverse competition.

Lack of adequate consumer information and of direct access to lower cost providers has led to reverse competition for title insurance. Exhibit XII-23 describes a simple model which may be useful in describing the various interactions, incentives, and directions of causation that characterize the market for title insurance. Reverse competition essentially is competition for referrals by providers rather than competition for the customers themselves. It both facilitates high prices which in turn results in potential high profits (to the system) and is strengthened by the availability of high prices and high profits. Higher prices are possible under reverse competition because those to whom consumers are referred are less sensitive to prices charged for title assurance services. Conversely, the existence of high prices and high profits strengthens reverse competition by increasing the potential profits that might result from additional referrals.

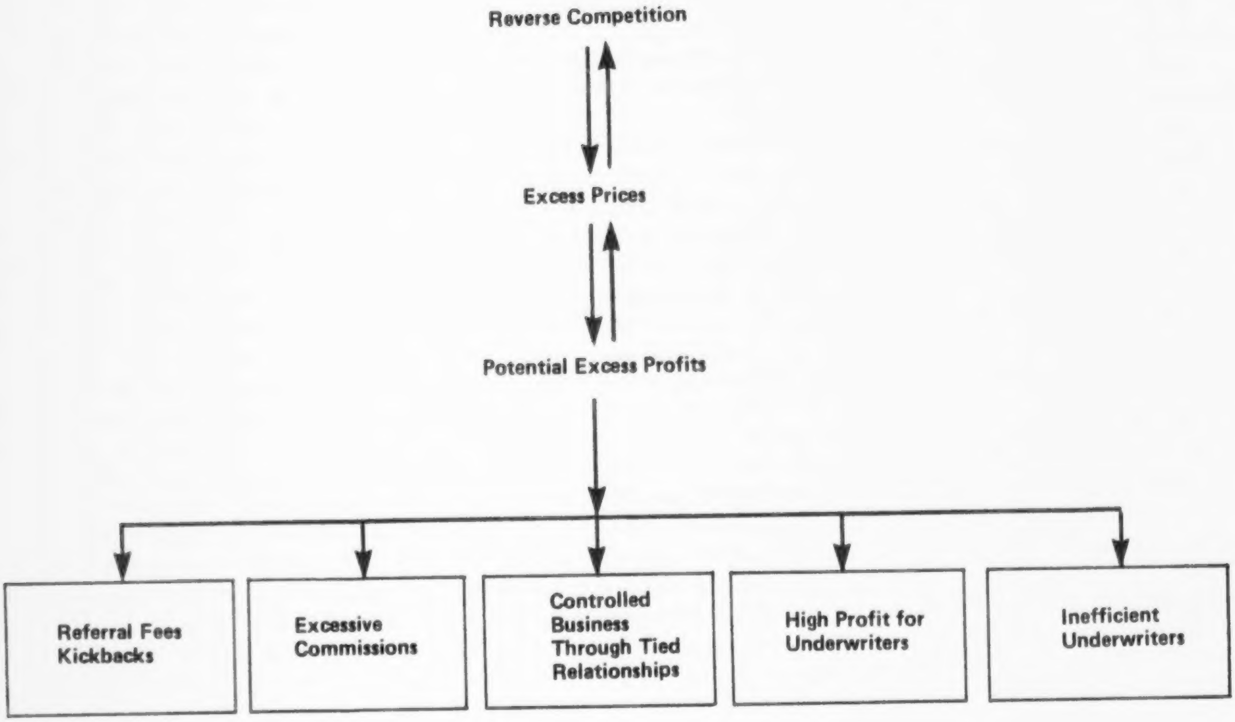
The potential excess profits shown in Exhibit XII-23 are potential to the system, but may not necessarily accrue to the underwriter. He may have to offer some of those potential excess profits in competing for referrals. They may be offered in the form of referral fees, kickbacks, or free services, all illegal under Section 8 of RESPA, or as high commission rates. In both cases, marketing expenses are likely to be high if they are viewed as helpful in increasing the number of referrals. Alternatively, sources of referral such as lenders and brokers may seek to internalize those excess profits by setting up their own title companies, generating referrals to those companies, and negotiating favorable terms with the title underwriters.

Under these three cases of reverse competition, the underwriter may have been forced by competitive pressures to give up all the excess profits. The underwriters may seek to retain these excess profits by establishing their own direct sales outlets. Underwriters may even engage in price competition, that is, offer title insurance services at prices below those charged by underwritten title companies, lawyer agents, and other retail providers in order to increase market share and retain some (of the now diminished) excess profits.

A final possibility is that high profits and the potential for excess profits will allow inefficient firms to survive and even prosper. Unlike a price competitive market situation where only the most efficient firms can successfully compete at the market price, the higher prices existing under reverse competition may provide inefficient firms with some extra breathing

EXHIBIT XII-23

RESULTS OF NONCOMPETITION IN THE TITLE ASSURANCE INDUSTRY


Reverse Competition
Excess Prices
Potential Excess Profits
Referral Fees Kickbacks
Excessive Commissions
Controlled Business Through Tied Relationships
High Profit for Underwriters
Inefficient Underwriters

SOURCE: PMM&CO., 1980.

room. Clearly, under reverse competition the extra profit, increased marketing expenses, and industry inefficiency occur at the cost of higher prices to the consumer.

Clearly for reverse competition to exist, a widespread system of referrals is necessary. Exhibit XII-24 (reproduced from Chapter V) shows the portion of business which title insurance underwriters believe they receive from direct contact and from different sources of referrals. Direct contact plays a small role. The referrers, real estate brokers, lenders, and attorneys are the major sources of business, as expected.

Kickbacks and Referral Fees

RESPA specifically prohibits payments for referrals in cases where no work is peformed. Section 8, which details this prohibition, was motivated by reports of cases in which realtors and developers were being paid by attorneys or title companies for referrals. Developers were in a particularly strong position because they could require, as a condition to purchasing a house, that particular title assurance providers be used. Sellers are now prohibited from requiring the use of a specific title insurer. However, they are permitted to recommend specific companies or individuals.

When respondents were asked whether the incidence of illegal payments (i.e., kickbacks and referral fees) involving title insurance companies had changed since the passage of RESPA, the answers were that the incidence had:

- increased - 2%
- decreased - 36%
- remained the same - 30%
- don't know - 32%

Of those who believe illegal payments are continuing, 44 percent indicated that some lenders are involved, 96 percent indicated some brokers, and 79.2 percent indicated some builders. While these figures do not prove that kickbacks are still prevalent, many professionals in the field believe that they are. According to HUD personnel, there has been almost no enforcement of Section 8 by the U.S. Department of Justice. Thus the continuation of these practices would not be surprising.

Commissions/Retentions

Another major marketing tool utilized by underwriters for increasing sales of their own title insurance, or increasing their market share, is the amount of the commission paid to agents. Unlike kickbacks and rebates, these commissions and premium retentions are completely legal since they were specifically exempted from coverage by Section 8 of RESPA if they cover services provided to issue the policy. The rationale for this exemption is based on the concept that those receiving a commission are performing some service other than simply referring the provider.

EXHIBIT XII-24

SOURCE OF REFERRALS, AS A PERCENTAGE OF TITLE INSURANCE BUSINESS (1)

	DIRECT CONTACT CUSTOMER (2)	TOTAL REFERRALS	BROKERS	LENDERS	ATTORNEYS	TOTAL
Entire Survey	18%	82%	49%	16%	17%	100%
Washington, D.C.	23	77	36	3	38	100
Jacksonville	16	84	18	27	39	100
San Antonio	18	82	62	4	16	100
St. Louis	19	81	62	10	9	100
Denver	10	90	70	15	5	100
Los Angeles	15	85	62	22	1	100
Seattle	22	78	32	41	5	100

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(1) PMM Title Insurer Survey, February 1980. The Boston SMSA was not represented in title insurance interview because of the predominant use of attorney opinions, as explained in the text.

(2) May be buyer or seller.

The agents receiving such commissions are usually directly involved in the sale of the insurance. They are either attorney-agents or underwritten title companies, rather than a direct branch of the underwriter, and they are responsible for their own costs.[1] Although the amount of the commission varies, their sole compensation from the underwriter is that they receive a percentage of the premiums they generate.

What has been called into question with respect to these practices is the relationship between the commissions retained and the services performed. The issue is intensified when the agent collects compensation for some of these services from other sources, i.e., the consumer. There are two basic patterns for the full compensation structure of agents. In the East, where attorney-agents are more common, the premium for title insurance is often limited to the "national risk premium" schedule. The consumer pays additional fees for the title search and evaluation. There may also be additional charges for document preparation, settlement, and other legal fees. The commission in this case is a percentage of the "risk premium". Our interviews indicate that 50 percent of the risk premium was a common retention rate. Sometimes this figure was as high as 60-65 percent. This type of structure existed for attorneys, underwritten title companies, and agencies.

In cases where the agent is compensated fully for the title search and other services through separate fees, the retained portion of the premium does not appear to represent work performed. The title insurance companies readily agree that the commission rate is used as a marketing tool for obtaining and keeping valuable agents. Based on our interviews, the retention rates of attorney-agents has risen in recent years. However, because the rate structure for the title insurance "risk premium" has been set for so long, the increase in retention percentages probably has not actually increased the insurance rate. Rather, there has been an income transfer from the underwriters to the attorneys. This may be an indication that the risk premium prices are too high. On a $60,000 house with a $50,000 mortgage, the risk premium for owners and lenders title insurance using the national rate would be $210.00. A commission of 50 percent would be $105.00.

The relatively high commission rates, or retentions, of title insurance agents may indicate that the insurance premiums are too high. The implication can operate profitably on less than half the total premiums paid for the risk component of title insurance.

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[1] Underwritten title companies may be owned by real estate brokers.

The second type of compensation structure exists in areas where an "all-inclusive" rate is charged for both the search and the insurance. These cases occur more often in the West where attorneys are not heavily involved in title assurance, and where the underwritten companies are the principal providers of title insurance. In many of these areas, commission rates of 80-90 percent are common, such as they are in Colorado, Texas and California. This percentage, however, refers to a premium which represents a combined cost of both the title insurance and the title search. It is also important to note that these higher commissions are often accompanied by a liability on the agent's part for a substantial portion of many claims and losses.

These commissions should not be compared to the 50-65 percent of risk premium common on the East Coast. While this second form of commission structure is designed to cover work performed, total prices may still be high. As previously discussed, total charges in Los Angeles are among the highest in the country.

The use of a commission structure is based on the concept that it reduces the total costs of the title insurance underwriter. When they sell through agents, whether through attorneys, agencies, or UTCs, the companies can expand their market share with only a minimal additional investment. Almost without exception, title insurance company representatives stated they preferred agencies in bad times and branches in good times. However, they also stated that they believed there was a long-run move toward the continued development of branch offices owned directly by the underwriter. Thus, the underwriters are able to save on the marketing value of commissions in the particular area. While it is possible that branches are a more profitable structure for the companies, there is no indication that consumers receive any lower prices from branches than from agencies if there is no pass through of cost reduction.

A number of participants in the settlement process, as well as numerous commentators, have expressed the opinion that the regular involvement of attorneys in the settlement process causes prices to be artificially high. Although our findings indicate that this is sometimes true, they do not support the contention that the absence of attorneys causes prices to be low. The highest prices found in the HUD-1 survey were charged by title and escrow companies in Los Angeles. It appears that each of the participants in the title and conveyancing markets have the potential to charge very high prices in some markets.

The selected sample sites where attorneys are primary settlement service providers are Boston, Jacksonville, and Washington, D.C. They also have a diminished but unique role in San Antonio. The HUD-1 data for these sites does not show a consistent pattern of particularly high prices. Nevertheless, certain observations and conclusions can be drawn.

Attorney-agent retentions and commissions are only one form of compensation to attorneys for real estate transfer work. As noted in Chapter V, attorneys have a critical and essential role in most, if not all, real estate transactions. The advice of attorneys in negotiating and structuring the terms of the sale, and in direction through the remainder of the settlement process, is often invaluable. Even in transactions which are apparently routine, there is always the potential for very real legal problems which would require legal advice from a qualified and experienced real-estate attorney.

This study has not undertaken to compile or evaluate the prices charged by members of the bar for legal advice. It is quite evident, however, that lawyers charge fees which reflect very specialized training and education in all areas of the law. Our findings make it quite evident, also, that these same rates are charged for routine title and settlement functions regularly handled by paralegals and clerical staff. This situation is demonstrated in the San Antonio SMSA, where UPOL regulation requires that the necessary documents must be prepared by an attorney. The effect of this has been to raise the total costs, from an "all-inclusive" regulated rate, by more than $75.00. It is also apparent in the Maryland suburbs of the Washington, D.C. SMSA, where both attorneys and title companies offer similar services in a single marketplace. In that case, the estimated pricing data showed that the same services are available from title companies for about $100 less than what attorneys generally charge.[1]

Finally, the lack of adequate consumer information regarding settlement services and prices may lead to overpaying for legal services or to choosing an inadequately experienced attorney. As noted previously, of the 21 percent of home buyers who paid for an attorney, only 18 percent spoke with more than one.

Interlocking Relationships

In addition to payments for referrals, implicit and explicit, reverse competition has contributed to patterns of interlocking business relationships between providers. These relationships provide the institutions involved with the opportunity to sell two or more services to a homebuyer and to benefit financially. It is unclear, however, whether consumers are adversely affected in terms of price or quality of service as compared to other forms of reverse competition. The provider could provide the second good at a lower than market price and thereby benefit the consumer.

Definition of Tied Sale, Referral, and Provider Relationships

In both the legal and economic literature, a tied sale is usually defined as the purchase of some good or service being predicated upon the purchase of some other good or service. There is usually a presumption of compulsion in that the ancillary good is required and must be purchased from a particular seller.

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[1] It should be noted that many consumers in Maryland are not able to take advantage of this apparent price break, since many Maryland lenders utilize the "review-fee" method of specifying the use of a particular attorney.

The provider of a particular good or service can also recommend or "refer" a provider of the ancillary service, but not require the buyer to purchase from the referred supplier. In the area of real estate conveyancing the distinction between a tied sale and a referral may not be very important because of the lack of adequate information consumers posess with regard to the services they are procuring and their inclination to select providers on the basis of referrals.

The issue of tied sales and referrals is especially important in light of the relationships which exist between the different service providers. The predominant forms of interlocking relationships involving title assurance providers are discussed in this chapter. The predominant form or these relationships are:

- lender-attorney; and
- real estate broker-title insurance company.

Lenders-Attorneys

As discussed in Chapter VI, in many areas attorneys are used to provide the routine conveyancing functions necessary to the transfer of real estate. Frequently lenders require that this procedure be performed by a particular attorney. Under the Federal Home Loan Bank Board Regulations, member associations are allowed to require that the specified attorney review the documents, at the borrower's expense, if the specified attorney was not used for preparation. Banks and mortgage companies also have this right, although not explicitly in regulations.

The practice of requiring the use of specific attorneys appears to be widespread. We asked lenders, "If an attorney selected by the borrower has performed the legal work necessary to complete the settlement process, would you additionally require a review by your own attorney?" The following percentages of lenders in each group replied yes.

Commercial Banks	45.5
Savings & Loan Associations	47.4
Mutual Savings Banks	52.9
Mortgage Banking Companies	25.8
Total Lenders	40.7

While some lenders in each SMSA affirmed this practice, it was most common in Boston (65 percent of all lenders), Washington, D.C. (66 percent of all lenders, although primarily in Maryland), and Jacksonville (66 percent of all lenders).

As discussed in Chapter VI, it is not always necessary to have an attorney perform the title and conveyancing functions. In most Western states, they are generally not involved in conveyancing. Document preparation is often performed by title insurance companies or real estate brokers. When title insurance companies perform the work, the company also insures that the work has been completed correctly. This combination of practices raises the question of whether lenders are adding to borrower closing costs by requiring borrowers to use an attorney. Of the institutions that require such a review, the following percentages require the borrower to pay a fee for this procedure:

· Commercial Banks	73
· Savings & Loan Associations	80
· Mutual Savings Banks	100
· Mortgage Banking Companies	60
Total Average	76

Clearly borrowers are directly paying for the legal work. Since in many cases the functions could be performed less expensively by non-attorneys, or by an attorney of the borrower's choosing, the additional costs may be unnecessary.

Maryland is one area where conveyancing services are available through either title insurance companies or attorneys. The review requirement is widespread in Maryland, including the suburbs of Washington, D.C. Thus, a home buyer may be effectively prohibited by the lender from obtaining conveyancing services through a title insurance company. The data presented earlier show that for a typical $60,000 house, the charges for title assurance and conveyancing services in the Maryland suburbs is approximately $100 higher when purchased through an attorney instead of a title insurance company. We are not aware of any quality differences when this work is performed by an attorney or a title company. In fact, some title companies have attorneys on their staff to act as settlement agents.

The attorneys who represent specific lenders are, of course, assured a steady flow of real estate business. Many are attorney-agents for specific title insurance companies. Since the consumer, in almost all cases, pays less by having all of the work performed by the lender's attorney rather than using his own attorney and then going through the review procedure, the lender's attorney in many cases is chosen to perform the title search and evaluation and sell the title insurance, in addition to performing closing, escrow, and document preparation. As with most attorney-agents, a portion of the insurance premium may be retained in addition to separate charges which may be charged for the search and evaluation and conveyancing procedures.

There does not seem to be any indication that lenders have attempted to keep the attorney fees low.[1] The review requirement is often localized and does not exist throughout the country. However, practices do tend to be consistent within a given area and often continue to persist in the absence of competitive pressure. These practices are in conformance with the Federal Home Loan Bank Board regulations. Our interviews indicated that such tied relationships frequently exist. How extensive the practice is outside of the eight sites in not clear, but presumably in those areas where attorney involvement in real estate transfer is widespread (or even mandated by UPOL rules) the situation is more likely to exist than in other areas.

Real Estate Brokers - Title Company

Another tied relationship that has gained special attention in the past few years is the broker-owned title company. In these cases, a broker, or group of brokers, set up an underwritten title company. The broker's company performs the search and evaluation and writes the insurance policy as an agent for an underwriter. Consequently, the policy is insured by a larger title insurance company, and losses, including those which result from an inadequate search, will be paid by the underwriter.

Because of the position of the broker in the process, he can refer business to his own title company. This puts a broker in an especially strong position, both to profit from his own referrals and to develop a superior bargaining position with prospective underwriters.

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[1] See Professor John C. Payne, "Closing Costs and the Mortgagee," Federal National Mortgage Association, 1979 General Counsel's Conference (Savannah, Georgia). Professor Payne is of the opinion that the lender's attorney is not under pressure to reduce charges.

While the title insurance industry underwrites these firms, they have as a group, been adamantly against these tied relationships, which they call controlled business.[1] The fear apparently is based on the assumption that if broker-owned title companies become widespread, the insurance industry would have to deal through them exclusively. Underwriters would be hampered in their ability to continue the trend of operating through their own branches and agencies. In addition, if an underwritten title company were tied to a large segment of the brokerage industry, it could take advantage of its market share in negotiating for agency retentions and other financial arrangements from the underwriters.

It remains unclear how extensive the controlled business movement actually has become. When we asked title company personnel in the eight sites whether they thought there was a local trend to controlled business, 37 percent said yes. This figure ranged from a high of 100 percent in Los Angeles to 0 percent in Seattle. Jacksonville and St. Louis were both 40 percent.

The title insurance industry alleges that controlled business will lead to poor quality work (presumably in searches) and higher prices. Since the insurers themselves have every incentive to make the underwritten company provide a good quality search and examination, this argument is not very persuasive. However, the assumption that controlled business could lead to higher prices needs some discussion. The only empirical evidence that we are aware of is the Coldwell-Banker case. Coldwell-Banker, a large brokerage firm in California, attempted to set up its own title company, Guardian Title Company. They owned an escrow company which according to evidence presented at the Guardian application hearing, charged 50 percent more than competitors.[2] In this case it is quite clear that the broker-owned title company had higher prices than average (for the area). The possibility that such a market imperfection would continue to exist on a long-term basis is strong, primarily because of the assured flow of business from the broker.

This situation is analogous to the lender-attorney situation previously discussed. Both practices can exist and even prosper because of the reverse competition aspect of title insurance. If the majority of consumers understood, shopped for, and had unimpaired access to providers of title assurance, these types of practices could not exist in the long run because consumers would go elsewhere. Even though brokers cannot require that they supply the title or conveyancing services as lenders can, it is simply unrealistic to assume that home buyers will develop the knowledge or expertise necessary to ignore a broker's referral.

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[1] See American Land Title Association, The Controlled Business Problem in the Title Insurance Industry (November 1979).

[2] State of California, Department of Insurance, Findings of Fact, Conclusions of Law, and Recommendation in the Matter of the Application of Guardian Title Company, a California Corp., for organizational Securities Permit, File No. L-67, UTC LA-70, October 27, 1976.

Our interviews indicated that while RESPA may have contributed to the recent increase in controlled business, it was not the sole cause; broker-owned firms had existed before RESPA. The boom in housing markets during the 1970s made title work more profitable than it had been and encouraged entry into the field. Broker-owned title companies were one form of entrant.

Clearly the real debate over controlled business, as well as agent retentions and referral fees, is over who receives the potential excess profits, the underwriters or the local providers of the title assurance. If potential profits from providing title assurance and conveyancing services were not already high, brokers would be less likely to enter the business. Tied relationships may prohibit price competition, but they come into existence because prices are already high. Exhibit XII-23 portrayed this dual position of high prices earlier. Our study of the title assurance services confirms this view.

LEGAL SERVICES

This section has focused on the provision of title assurance and conveyancing services. The role of attorneys in providing these services has been addressed. Also discussed at length was attorney involvement with lenders and title insurance companies. There are several issues however, involving attorneys which transcend title assurance or the provision of conveyancing services. In 1975, the U.S. Supreme Court held in the Case of Goldfarb v. Virginia State Bar that bar associations could no longer establish minimum fees. In the Bates v. State Bar of Arizona case, the Supreme Court held that attorneys cold advertise their services. The question arises as to what effect these decisions have had on the cost and provision of settlement services. Another issue regarding attorneys is the representation of more than one party in the settlement process. These three areas will be addressed in this section.

Attorney Minimum Fees

Until 1975, bar associations often developed minimum fee schedules for specific legal services. Thus, new and young attorneys could not charge less than prevailing prices to gain a competitive advantage. When this practice was held in the *Goldfarb* decision to be price fixing and a violation of the anti-trust laws, individual attorneys were free to charge whatever fees they wanted for legal services. The expectation by some was that competitive pressures would drive prices down.

In the PMM&Co. survey of attorneys, 8 percent said they had lowered their fees since *Goldfarb* and 92 percent said they had not. When asked whether attorneys in general had become more price competitive since Goldfarb, 30 percent said yes and 70 percent said no.

It is difficult to interpret the answers with regard to absolute prices because the inflation rate has been so high in the intervening period of time. However, the fact that 30 percent of the attorneys at least believed the profession was more price competitive, whether they had lowered their own prices or not, indicates a perception of change which may become more widespread in the future.

Our interviews suggest that price cutting is still not the norm in the profession although for some services, such as no-fault divorces, it is becoming common. Of some additional interest is the method by which attorneys charge. In our survey the method of charging was:

53%	by the hour
39%	flat fee
8%	by house price

It remains unclear as to whether these figures refer to title insurance or only conveyancing services. However, 67% of the attorneys interviewed were not attorney agents. Their role would probably be limited to conveyancing services and arranging for title assurance but not providing it themselves.

Attorney Advertising

Prior to the Bates decision, bar associations would not allow advertising or solicitation of business. This practice was also true in several other professions, such as medicine. Since the Bates decision, however, professional advertising is legal and cannot be prohibited by professional groups.

Of 91 attorneys interviewed in the PMM&Co. survey, only one advertises for real estate settlement services. That attorney advertised int he newspapers but not the telephone yellow pages.

One reason that advertising settlement services is not common may be the entrenched referral systems that characterize the settlement service process. Advertising is probably less efficient as a business development method than building a referral network. Further, in areas where lenders require the use of a specific attorney for a review process, a consumer would not be effectively free to respond to advertising.

Dual Representation

It is common in real estate transactions for one attorney to represent more than one participant in the process. The parties with a legal concern are the (1) buyer (2) seller, and (3) lender. Rarely are three attorneys involved.[1] In our survey, 41 percent of the attorneys never represented more than one party. Of the ones who did, they represented the following combinations:

Combination	Percentage of Dual Representation
Buyer and Seller	41.5
Buyer and Lender	20.8
Buyer, Seller, and Lender	37.7
	100.0%

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[1] As stated previously, in most areas of the country, no attorney is involved. Attorney involvement is primarily an East Coast phenomenon.

Dual representation is not illegal. In the vast majority of cases it is probably an efficient system. Certainly having two or three attorneys perform routine conveyancing services such as document preparation would be prohibitively costly to the transfer process.

The problem arises when the interests of the various parties diverge. This is most likely to occur with buyers and sellers, but could also occur between lenders and buyers. In these situations neither party may be receiving adequate representation, regardless of who pays the attorney directly. Requiring separate legal representation for each party would be costly and not necessary in most cases. One alternative is for parties involved in a settlement to be notified of the multiple representation role of the attorney and be advised to consider hiring their own attorney if legal problems are anticipated.

CONCLUSIONS

Charges for title assurance and conveyancing services vary by over 100 percent among sites. If it could be shown that costs of operations varied geographically, the price differential might be acceptable. However, this was not the case. All of the sites were SMSAs in which title plants were common and public records were searched only infrequently. The most common explanation for differing costs and practices was historical development of the title industry. No other explanation could be found in most cases. If this reasoning is correct, traditional economic assumptions regarding competitive markets are not relevant to this industry, even without the overriding characteristic of reverse competition. Under pure competition, prices adjust to markets over time. However, the combination of reverse competition and prices set by historical and customary practices has led to excess revenues which either are used to obtain referrals or contribute to underwriter profit. The forms that referral payments have taken are large commissions and interlocking relationships, primarily between attorneys and lenders, and brokers and underwritten title companies. In the case of interlocking relationships, the excess profits flow to brokers or attorneys. Large potential profits in the title insurance industry can also cause inefficiency. Thus, companies which are poorly operated can continue to exist because general prices are high enough to cover their costs.

While more study is needed to determine what an equitable rate structure would entail, some conclusions can be drawn with regard to the present pricing systems. There appears to be little or no basis for charging by house price. The major losses are due to overlooked mechanics liens and taxes at the time of the search which are unrelated to sales price. Nor are search costs related to house value. If the major cost of producing title assurance services is constant, the pricing structure should not be tied to an artificial index such as house price. Other industry costs such as high commissions, kickbacks, and other referral fees serve to inflate the cost of producing insurance. They are not legitimate marketing costs.

While marketing practices vary from one area to another, the final product remains the same. The goal is to assure that the property being transferred is free of encumbrances. The criteria established at the beginning of Part II for judging an industry were:

- the existence of workable competition; and
- well served consumers in terms of service and product provision.

The major findings of this study show that the markets for title assurance and conveyancing services are not characterized by workable competition. Nor do they perform well in most localities in terms of providing consumers with required settlement services at a price which approximates the cost of efficiently providing those services.

PART 3: IMPACT OF RESPA

The success or effectiveness of RESPA is premised on its ability to bring about active price competition in the settlement services markets and, by implication lower prices for settlement services. "Effectiveness" refers to the extent to which program inputs (i.e., RESPA's provisions, rules and regulations) lead to desired program outputs (i.e., greater and more active price competition among settlement service providers and lower settlement service prices). That is, RESPA's effectiveness is measured by the amount of change in the direction of more price competition in the settlement service markets and lower settlement prices as a result of compliance with RESPA provisions.

We distinguish the effects of RESPA from the effectiveness of RESPA. The Act may have had a number of effects or impacts on the settlement service markets. Some of these are desirable and intended changes in the market for settlement services. Others are unintended effects which may be either benign or undesirable. For example, some proponents of RESPA argue that consumers shop more for settlement services as a result of reading the HUD Special Information Booklet and studying the lender's Good Faith Estimates of settlement costs, and this, they claim, has resulted in lower prices, an intended and desirable effect. On the other hand, some industry observers cite RESPA as a major contributing factor in the rise of controlled business, tighter referral arrangements, and other forms of tied relationships--unintended effects of the legislation. Part 3 discusses the major impacts or effects of RESPA on settlement practices and costs, with particular emphasis on the extent to which the objectives of the Act have been met.

We use a model-based approach for assessing the effectiveness of RESPA. The model consists of three discrete but interrelated components:

- Compliance/Implementation - The extent of compliance with RESPA's rules, regulations, and provisions and the degree to which they are fully implemented and are an ongoing part of the settlement system.

- Systems Changes - The extent to which certain structures, practices, and relationships within the settlement industry and certain consumer behaviors and actions have changed as a result of the implementation of RESPA.

- Price Impact - The extent to which changes in the settlement markets have led to greater and more active price competition among providers and resultant downward pressure on the prices charged for settlement services.

Part 3 develops each of these components and discusses in detail how they are used to measure RESPA's effectiveness. Chapter XIII investigates the extent to which the provisions, rules, and regulations of RESPA are being compiled with and implemented. The compliance/implementation component of the model: (1) examines whether and at what time in the process lenders distribute the Special Information Booklet and Good Faith Estimates of closing costs; and (2) measures provider and consumer satisfaction with these requirements along with the perceptions and atttitude of both groups toward the Uniform Settlement Statement (HUD-1) and the provision concerning one day prior inspection of the HUD-1.

Chapter XIV discusses the components, which investigates the predominant changes in settlement practices, the settlement process, and the settlement service markets that have occurred since the advent of RESPA. Considerable emphasis is placed on consumer shopping for settlement services and the factors that may influence the level and amount of shopping. Two such factors are the Special Information Booklet and the Good Faith Estimates of settlement costs distributed by lenders to loan applicants. In addition, certain business relationships among providers, including tied relationships, controlled business, and referral arrangements are also considered in this component.

Finally, Chapter XV examines the third component of the model, price impact, the most difficult component to operationalize and quantify. Isolating the effect of RESPA on the prices charged for settlement services is virtually impossible as other factors which may influence price might also have changed since RESPA's inception. However, the existence and extent of changes in prices for settlement services since the enactment of RESPA, irrespective of source or cause, are investigated using time series data generated from surveys of HUD-1s conducted in 1975 and 1979.

XIII. COMPLIANCE WITH AND IMPLEMENTATION OF THE RESPA PROVISIONS

The first component of our model for assessing the effectiveness of RESPA and for cataloging the various effects of RESPA is the extent to which the provisions of the RESPA legislation and regulation are complied with and implemented. The RESPA regulatory apparatus contains several provisions which are discussed in some detail in Chapter I of this volume. These include:

- Lenders are required to give home buyers a copy of HUD's Special Information Booklet (SIB) within three business days of the loan application.
- Lenders are required to give home buyers good faith estimates (GFEs) of the costs they are likely to incur in conjunction with the settlement within three business days of the loan application.
- If the lender requires that the consumer use a particular provider of settlement services, then the lender is required to indicate whether there is a business relationship between himself and the required provider.
- The person conducting settlement is required to prepare a Uniform Settlement Statement (HUD-1) and allow the home buyer to inspect the HUD-1, to the extent it is completed, at least one business day before settlement, if the buyer so requests.
- The home seller is prohibited from requiring the buyer to use a particular title insurance company.
- RESPA places limitations on the amount of money that can be held in escrow accounts.
- RESPA prohibits kickbacks, certain referral fees where payment exceeds work and hidden payments. (Section 8)

In this section we consider the first, second, and fourth of these provisions. These three constitute the essence of RESPA in that they are the means by which consumers (in particular home buyers) acquire information about settlement services and prices. Such information is intended to induce home buyers to engage in greater levels of shopping which, it is expected, will exert downward pressure on the prices providers charge for their services.

The remaining provisions are not studied for the following reasons:

- Lender selection of specific providers. Lenders are required to indicate only whether they have a business relationship with the provider(s) they require consumers to use. This is distinct from indicating the nature of the business relationship, which is not a requirement of the legislation. For these reasons, HUD considered this requirement to be of secondary importance vis-a-vis the other provisions and requested that data collection and analysis resources be redirected to higher priority items.

- Prohibition of seller's requiring home buyer to use a specific title insurance company. HUD indicated that compliance with this provision was of secondary importance. The Department suggested that data collection and analysis resources be diverted to higher priority items.

- Limitations on the amounts that may be required to be placed in escrow. Measuring compliance with this provision required data that were available only with the permission of the lender and home buyer (e.g., the date of the first mortgage payment and the tax due date). For the purposes of this study these additional data were considered unavailable.

- Prohibitions against certain non-competitive behaviors on the part of providers. Certain sensitive questions relating to these prohibitions were struck from the survey instruments when they were reviewed by the Office of Management and Budget (OMB) and tested by PMM&Co. The data from the survey instruments formed the lion's share of the evaluation data base, precluding an analysis of these sensitive provider behaviors and relationships.

The balance of this section contains analyses of provider compliance with and implementation of the following RESPA provisions:

- HUD's Special Information Booklet;

- the lender's good faith estimates of settlement costs;

- the Uniform Settlement Statement (HUD-1); and

- the one-day prior inspection of the HUD-1.

It is important here to make a distinction between "compliance" and what may be termed "implementation". "Compliance" refers to meeting the letter of the law. For example, the lender is required to provide good faith estimates of settlement costs to the home buyer within three business days of the loan application. To measure compliance, we ask if the estimates are received within the required time frame.

"Implementation" on the other hand, refers to meeting the spirit of the law. For example regarding the GFEs the lenders may simply give the estimates to the buyer, or take time to explain the estimates. The estimates also vary in accuracy. Explanation, and accuracy all help to make the good faith estimates of greater value. They go beyond compliance and address the extent to which the intent of RESPA has been met.

SPECIAL INFORMATION BOOKLET

According to the regulation, the Special Information Booklet, which is prepared by HUD, is purchased by lenders and distributed to prospective home buyers within three days of their loan application. The basic compliance/implementation issues relating to the SIB, are:

- Is the SIB distributed to buyers?
- Is the SIB distributed within three business days of the loan application?
- Is the SIB adequate? In other words, if the booklet is read by buyers does it convey accurate information, is it easy to read and understand, and does it provide the types of information needed by buyers?
- What are the specific deficiencies of the booklet?

Findings pertaining to SIB compliance/implementation are based on three data sources:

- in-person interviews with 638 buyers (referred to as "in-person buyers") from eight SMSAs;
- in-person interviews with 269 lenders from the same eight SMSAs; and
- telephone interviews with 670 buyers (referred to as "telephone buyers") from another 10 SMSAs, different from the eight.

The telephone buyer interview is an abridged version of the in-person buyer interview. Due to skip patterns and nonresponse, differing numbers of buyers responded to any given question. Thus, percentages do not always refer to the same number of lenders or buyers. Findings related to the use of the SIB are discussed below.

Receipt Of The SIB

The key findings relating to the receipt of the SIB by home buyers are:

- All but one of the 267 responding lenders reported that they distribute the SIB (see Exhibit XIII-1);
- Approximately 57 percent of the buyers surveyed reported receiving the SIB (Exhibit XIII-1);
- About 15 percent of the buyers receiving the booklet indicated that a provider other than the lender (real estate agents, attorneys) gave them the booklet.

These conflicting findings can be explained in two ways. First, it is possible that many buyers did not receive the SIB i.e. that lenders are not really distributing the SIBs. Lender interviews were completed with high-level officials who are not likely to conduct and process loan applications. Their responses may reflect their institutions' policies concerning SIB distribution rather than their implementation of these policies.

The second possible explanation is that buyers forget or simply do not realize that they received the SIB. Two observations support this explanation. First, both telephone and in-person buyers went to settlement between one and six months before the date of the interview. The SIB itself may have been received a few weeks or months before the closing. Therefore, lack of buyer recall may in part explain these findings. Second, the SIB itself is often printed as a medium-sized (4"x 8 1/2") pamphlet, and some respondents may have thought that the interviewer was referring to a document of greater size or bulk. Since the SIB is often handed to respondents with little explanation and along with other items such as the GFEs it is not surprising that buyers may forget or do not realize that they received the SIB.

When The SIB Is Received

The key findings relating to timing of the distribution of the SIB are:

- All but 6 of the 267 responding lenders maintained that they distribute the SIB to home buyers within three business days of the loan application.
- Of the buyers reporting receipt of the SIB, approximately 85 percent claimed they were given the SIB within the required time frame (Exhibit XIII-1).

EXHIBIT XIII-1

RECEIPT OF THE SPECIAL INFORMATION BOOKLET AS REPORTED BY TELEPHONE AND IN-PERSON BUYERS

SMSAs / RECEIPT OF SIB	ALL BUYERS	ALL SMSAs IN-PERSON BUYERS	ALL SMSAs TELEPHONE BUYERS	IN-PERSON BUYER SMSAs								TELEPHONE BUYER SMSAs									
				BOSTON	DENVER	WASHINGTON, D.C.	JACKSON-VILLE	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE	PHOENIX	SAN FRANCISCO	ATLANTA	CHICAGO	LOUISVILLE	NEW ORLEANS	LAS VEGAS	NEWARK	PHILA-DELPHIA	NASHVILLE
PERCENT RECEIVED SIB	57.0	53.2%	60.7%	67.1	56.3	71.4	26.0	49.2	64.3	50.0	38.2	53.8	52.3	74.7	58.1	63.5	67.8	47.6	71.0	83.3	45.5
SIB RECEIVED AT OR BEFORE TIME OF LOAN APPLICATION	72.9	76.1%	66.9%	68.6	72.3	74.0	82.6	51.7	81.4	89.2	80.8	80.0	52.9	79.5	72.2	77.5	89.2	63.3	36.7	78.0	73.3
SIB RECEIVED WITHIN THREE DAYS OF THE LOAN APPLICATION	10.0	8.6%	11.4%	7.8	6.7	8.0	4.3	31.0	9.3	0.0	3.8	11.4	11.8	11.4	8.3	5.0	2.7	13.3	32.6	4.0	10.0
SIB RECEIVED AFTER THREE DAYS OF THE LOAN APPLICATION	18.4	15.3%	21.3%	23.5	11.0	18.0	13.0	17.2	9.4	10.8	15.3	8.6	35.3	9.1	19.5	17.5	8.1	23.3	30.6	18.0	16.7
SAMPLE SIZE NUMBER OF BUYERS WHO REPORT RECEIPT OF SIB	699	314	385	51	45	50	23	29	43	37	26	35	34	44	36	40	37	30	49	50	30

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

The difference in these proportions is statistically significant. One probable explanation for the discrepancies, supported from our discussions with groups of consumers before the survey instruments were developed, is that some buyers may be confused as to when the loan application actually took place. In some instances, the buyer may discuss a loan with a lender. The lender may ask several questions at this time, but the formal loan application may take place at a later date.

Adequacy Of The SIB

The key findings pertaining to the adequacy of the SIB are as follows:

- About 85 percent of the lenders (and attorneys and title insurers) interviewed believed the SIB contained no inaccuracies or misrepresentations;
- About 75 percent of the buyers who read the SIB report that they found the SIB extremely helpful or somewhat helpful; and
- More than 85 percent of the buyers who read the booklet indicated they believed it was written in an understandable manner.

One should not interpret these statistics as conclusive evidence of the SIB's adequacy. Survey respondents were not given any frame for comparison (e.g., an alternative or region-specific SIB to examine). In this context, respondents tend to be satisfied unless they remember specific problems or deficiencies.

Specific SIB Deficiencies

Relatively few providers and buyers made comments regarding specific deficiencies in the SIB. Those that did were distributed as follows:

- 32 of 269 lenders;
- 7 of 63 attorneys;
- 5 of 43 title insurers; and
- 22 of 213 buyers.

Deficiencies reported by the providers include:

- The SIB is too generalized and lacks sufficient discussion or regional variations from the generic (19);

- The SIB is written in an "accusing" tone, i.e., implying that lenders and other providers could not be trusted (6);

- Miscellaneous others (19).

In addition, when asked when should the SIB be distributed to be most beneficial from the buyer's perspective, 70 percent of the responding home buyers suggested that it should be distributed at first contact with the real estate agent. Several lender comments support an earlier than current practice distribution of the SIB as well.

GOOD FAITH ESTIMATES

Within three business days of the time of loan application, lenders are required to provide home buyers with good faith estimates of the charges buyers are likely to incur in conjunction with the settlement. The compliance and implementation issues relating to the GFEs are:

- Do home buyers receive good faith estimates?

- Do home buyers receive GFEs within the required time frame?

- In what form do home buyers receive the GFEs? These include:

  - itemized estimates versus one total estimate for services rendered; and

  - range estimates versus fixed estimates for given services.

- How accurate are the GFEs?

- How comprehensive are the GFEs (i.e., are estimates provided for all settlement services for which the home buyer is charged at closing)? and

- Do lenders explain the GFEs to home buyers?

Clearly, the GFEs constitute a more substantial implementation component than the SIB, as they require greater effort on the part of the lender. Receipt and the timing of receipt of the GFEs deal with compliance. The lender's efforts to develop accurate and comprehensive estimates and to present and explain them effectively to home buyers are important implementation issues that affect future buyer behavior.

Timely Receipt Of The GFEs

The key findings pertaining to the receipt of the GFEs are as follows:

- All reporting lenders indicated they provide GFEs to the home buyers;
- 95 percent reported they provide them to consumers within the required time frame;
- 83 percent of the buyers report receiving the GFEs (Exhibit XIII-2);
- Of the buyers reporting receipt of the GFEs 75 percent indicated receiving them during the required time period.

While the differences in the lender and buyer responses are statistically significant, they are not as substantial as the lender/buyer differences relating to the SIB.

One explanation for the inconsistency between lender and buyer findings is that the receipt of good faith estimates is a more noteworthy event than the home buyer's receipt of the SIB as more than 75 percent of in-person buyers who report receiving GFEs state that the lenders explained the estimates to them.

Form Of The GFEs

The key findings relating to the form of the GFEs are as follows:

- Over 75 percent of the responding lenders claim they use their own form as opposed to the HUD-1 in presenting the GFEs.
- Almost 65 percent of the responding lenders reported that they use their own survey of settlement costs to develop GFEs, the balance use actual costs displayed on HUD-1s from previous transactions.
- 87 percent of the responding lenders presented the GFEs in the form of a point estimate as opposed to an interval or range estimate.
- 87 percent of the responding consumers indicated receiving fixed estimates.

EXHIBIT XIII-2

RECEIPT OF GOOD FAITH ESTIMATES AS REPORTED BY TELEPHONE AND IN-PERSON BUYERS

SMSAs / RECEIPT OF GFEs	ALL BUYERS	ALL SMSAs IN-PERSON BUYERS	ALL SMSAs TELEPHONE BUYERS	IN-PERSON BUYER SMSAs								TELEPHONE BUYER SMSAs									
				BOSTON	DENVER	WASHINGTON, D.C.	JACKSONVILLE	LOS ANGELES	ST. LOUIS	SAN ANTONIO	SEATTLE	PHOENIX	SAN FRANCISCO	ATLANTA	CHICAGO	LOUISVILLE	NEW ORLEANS	LAS VEGAS	NEWARK	PHILADELPHIA	NASHVILLE
PERCENT RECEIVE GFEs	83.4	85.8%	81.2%	94.9	91.6	87.7	88.0	87.0	89.3	90.8	77.5	83.3	94.5	84.4	76.7	83.9	79.4	74.6	76.2	96.7	73.6
GFEs RECEIVED AT OR BEFORE TIME OF LOAN APPLICATION	51.1	54.3%	48.0%	29.7	69.4	36.1	64.9	45.3	59.7	68.3	66.1	55.3	29.1	38.9	67.3	65.3	59.2	46.5	33.3	55.9	28.3
GFEs RECEIVED WITHIN THREE DAYS OF THE LOAN APPLICATION	20.5	21.2%	19.8%	24.3	16.7	41.0	14.0	32.1	16.1	11.7	15.3	19.1	22.9	14.8	10.9	18.4	16.3	20.9	33.3	16.9	26.1
GFEs RECEIVED AFTER THREE DAYS	28.4	24.6%	32.1%	46.0	13.9	23.0	21.1	22.7	24.1	20.0	18.7	25.6	48.0	46.3	21.8	16.3	24.5	32.6	33.4	27.2	45.6
SAMPLE SIZE-NUMBER OF BUYERS WHO REPORT RECEIPT OF GFEs	999	510	489	44	72	61	57	53	62	60	59	47	48	54	48	48	48	43	48	59	46

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

Accuracy Of GFEs

Key findings regarding the accuracy of the GFEs are:

- 79 percent of the lenders reported that the GFEs are close approximations of the actual prices charged; 21 percent reported that the estimates tend to be higher than the actual charges.

- Over 90 percent of the responding buyers reported that the GFEs are reasonably accurate estimates of the amounts they are charged; unlike lenders, 60 percent of those who felt the GFEs are inaccurate claim that they are biased downward, that is, they underestimate actual charges.

Comprehensiveness Of GFEs

In-person buyers were also asked, at closing, if they were charged for any services or activities for which they did not receive a good faith estimate. Only 6.5 percent (24 out of 526 respondents) reported that this happened.

Buyers who reported missing estimates were asked to which activities or services they pertained. Thirty-three percent (11 out of 33 responses) reported that the missing estimates deal with lender related charges.

Lender Explanation Of GFEs

Over 75 percent of the responding in-person buyers (408 out of 530 respondents) reported that lenders take time to explain the GFEs to them.

UNIFORM SETTLEMENT STATEMENT - THE HUD-1 FORM

One way in which RESPA promotes consumer understanding of the settlement process is through the use of the Uniform Settlement Statement, the HUD-1 form, which identifies, itemizes, and categorizes individual settlement costs. Compliance/implementation issues here include:

- How useful is the HUD-1 form for summarizing the buyer/seller transaction and settlement charges?

- Do consumers find the Uniform Settlement Statement difficult to understand?

Usefulness Of The HUD-1 Form

Both lenders and title insurers are quite critical of the HUD-1 form. Over 50 percent of responding title insurers and over 40 percent of responding lenders felt that the form is either slightly useful or not at all useful. Only 19 percent of the attorneys shared this opinion. It is possible that attorneys do not have as much trouble with the Settlement Statement because their work often requires them to deal with complex technical and legal documents that they decipher and explain to clients.

Providers identified specific problems or additional information that might be needed to improve the HUD-1 form, including:

- a need for clearer and more detailed breakdowns of such items as title charges and insurance as well as mortgage terms;
- a need for modifying specific line items (e.g., line 501, excess deposits); and
- definitional/interpretive problems with the HUD-1 line items that result in difficulty with determining where a specific change or piece of information should be placed on the form.

These concerns, especially the third one, are reflected in the analytic limitations of the HUD-1 data which are presented elsewhere.

Approximately 80 percent of the responding buyers and sellers report that the HUD-1 form is a useful document. Specifically, about 85 percent of responding buyers say the form is useful. Approximately 70 percent of the sellers found the form useful.

Consumer Understanding Of The HUD-1 Form

Approximately 71 percent of the consumers reported that they did not require assistance to understand the HUD-1 form, a percentage which should be tempered with the knowledge that interviewees are traditionally reluctant to admit confusion.

Problems consumers indicated they had with the HUD-1, in the order of their frequency, are as follows:

- lack of understanding of specific settlement services (28 percent);
- cost breakdown between buyer and seller, i.e., why does the buyer pay for certain services and the seller for others (20 percent);
- terminology too complex (19 percent); and
- miscellaneous others (33 percent).

ONE-DAY PRIOR INSPECTION OF THE HUD-1 FORM BY BUYERS

RESPA requires the settlement agent to allow buyers to inspect the HUD-1 form at least one business day prior to closing, upon the buyer's request. Compliance and implementation issues relating to the one-day prior inspection option are:

- How many buyers request the one-day prior inspection?
- Do providers allow buyers to inspect the HUD-1 form one day prior to inspection?
- How complete is the HUD-1 form on the business day before closing?
- Are the fees listed on the HUD-1 form one day before closing the same as those listed at the time of closing?

This requirement is not intended nor expected to directly affect shopping behavior, but rather to allow the buyer to know closing costs before the closing.

Buyers Requesting One-Day Prior Inspection

Approximately 20 percent of the in-person buyers reported that they asked for the HUD-1 prior inspection. Buyers who had not requested the prior inspection were asked if they were aware of their right to make such a request. Of the responding buyers, 78 percent said they were not aware of this opportunity. Statistics indicate that most buyers either:

- waive the right to inspect the HUD-1 form; or
- are not aware of their right to inspect the HUD-1 one day prior to closing.

Lenders, attorneys, and title insurers who conduct settlements were asked what proportion of buyers they feel request the one-day prior inspection. Virtually all of these providers reported that less than 5 percent of all buyers request the inspection. These differences can be partially explained by the fact that consumers who, in fact, did not exercise their right to prior inspection may have been reluctant to admit to the interviewer their waiving such a right. Therefore, the proportion who claim that they made the request may exceed the proportion who actually made the request for the one-day prior inspection.

A few providers, however, did report substantially higher percentages which are more in line with the consumer findings. This may be explained (in at least one case) by the fact that these providers, as a matter of conducting business, inform buyers of their right and provide consumers a copy of the HUD-1 prior to closing, whether the inspection is requested or not.

Providers Allow Buyers To Inspect HUD-1s If Requested

Unfortunately, due to a faulty skip pattern in the buyer's instrument, all buyers (not just those who requested prior inspection) were asked if they were allowed to see the HUD-1 form one day prior to closing. A total of 191 buyers reported that they did see the HUD-1, although only 121 buyers made the request. It is possible that there is not a great deal of overlap between those 121 buyers who made the request and the 191 buyers who saw the HUD-1, given that 559 buyers responded to this question. However, it seems more likely that the requests were indeed honored. The additional 70 buyers who saw the HUD-1 probably reflect the policies of those providers who send out the HUD-1 form in advance of closing whether or not requests are received.

Completeness Of HUD-1 Form One Day Before Closing

More than 80 percent of all responding providers, i.e., those who conduct settlements, report that the HUD-1 is more than 75 percent complete on the business day prior to closing. Specifically, 83 percent of the attorneys and title insurers and 93 percent of the lenders interviewed made this response.

Providers were also asked the services for which costs were commonly unavailable one day prior to closing. Lender fees are reported as the cost item that is most frequently unavailable on the business day before closing. One should note that this does not reflect the completeness of the HUD-1 in terms of identifying all costs. For example, the analysis of our nationwide sample of HUD-1s strongly suggests that, quite often, the broker's commission/fee is omitted from the HUD-1 entirely.

Comparability Of Fees At Inspection And Closing

Buyers interviewed in person were asked if the services and fees identified on the HUD-1 form one day prior to settlement were the same as those listed at settlement. Nearly all of the buyers, 94 percent, reported that the services and charges were the same.

CONCLUSIONS

The main findings regarding compliance with and implementation of the RESPA provisions examined are:

- Nearly all lenders claim to be complying with the requirements of distributing the SIB and GFEs within the required time frame;

- A substantial proportion of consumers (approximately 43 percent) claim they do not receive the SIB.

- Most consumers and providers found the SIB adequate, but too general, lacking sufficient explanation of regional differences;

- Approximately 83 percent of consumers receive the good faith estimates;

- A large proportion of providers and consumers view the GFEs as reasonably accurate estimates of actual settlement charges. Consumers find the GFEs comprehensive and accurate.

- Few home buyers exercise their right to a one-day prior inspection of the Uniform Settlement Statement (HUD-1). Providers indicate the form is often only 75 percent complete at this time.

- Both providers and consumers have substantial complaints about the HUD-1. They claim it is too complex, it is difficult to understand, and it possesses definitional and interpretive problems.

XIV. CHANGES IN THE SETTLEMENT PROCESS AS A RESULT OF RESPA

This discussion focuses on the changes in the behavior of consumers of settlement services since the advent of RESPA. Recall that the objective of the RESPA legislation was to reduce the need for referrals by promoting consumer shopping for settlement services. HUD's Special Information Booklet was designed and developed to make consumers aware: (1) that settlement service prices are not fixed, and (2) that they could (and should) shop among providers of settlement services.

This section examines:

- the extent and dimensions of the readership of the HUD Special Information Booklet;
- the general level of consumer shopping and the factors that influence the level of shopping; and
- the proportion of all consumers of settlement services who are influenced to shop as a direct consequence of the RESPA provisions.

No attempt is made to assess the effects of the Good Faith Estimates (GFE) on shopping, for two reasons. First, it is the study team's understanding that the primary purpose of the GFEs is to provide consumers with an estimate of the kinds and amounts of charges they are likely to incur in the settlement, not to promote and stimulate consumer shopping of settlement services. Second, the GFE's marginal effect on shopping as distinct from the impact of the SIB (which was intended to be the main catalyst in inducing consumers to shop) on shopping is a subtle nuance that was not assessed due to methodological and analytical limitations.

Changes in the behavior of the providers of settlement services since the passage of RESPA are not discussed here. The impact of the Section 8 prohibitions against kickbacks and hidden payments and the rise of certain business relationships such as interlocking directorates have been withheld from this discussion due to two factors:

- The problem of self-incrimination on the part of survey respondents. It is difficult to gain a full and clear understanding of provider behavior and relationships without asking a given provider how he himself operates in the settlement service market. However, certain responses to particularly sensitive questions may lead a respondent into a self-incriminating situation, potentially punishable by law. PMM&Co.'s general counsel urged the project team to strike certain of these questions from the instruments to eliminate the potential for self-incrimination.

- The elimination of specific questions from the survey instruments relating to provider behavior and relationships in the Office of Management and Budget (OMB) review of the data collection plan. OMB reviews all survey instruments for government-initiated surveys of more than nine respondents. In their review of the RESPA instruments, OMB determined that certain sensitive questions pertaining to Section 8 prohibitions and other provider behaviors and relationships be struck from the instruments.

As the data from the instruments formed the large proportion of the evaluation data base, the elimination of these sensitive but important questions precluded the possibility of identifying and analyzing changes in joint behavior since RESPA.

READERSHIP OF THE HUD SPECIAL INFORMATION BOOKLET

By providing basic information about settlement, the settlement process, the settlement providers and the consumer's right to shop for settlement services, HUD sought through its Special Information Booklet (SIB) to make consumers more knowledgeable about settlement procedures and to encourage them to shop among settlement service providers. An increase in consumer shopping, it was believed, would lead to greater price competitive settlement service markets. This in turn would result in reductions in the prices providers charge for their services.

Two important determinants of the effectiveness of RESPA are the extent to which consumers are receiving and reading the HUD Special Information Booklet. Chapter XIII addresses the extent to which the SIBs are distributed to home buyers. This section considers SIB readership from two aspects:

- the extent to which home buyers who receive the SIB read it; and
- the demographic characteristics of the SIB readership.

Extent Of Readership

The in-person and telephone interviews with consumers produced data on whether consumers who receive the HUD SIB read it and the care with which they read the booklet. Exhibits XIV-1, presents these data for the full set of buyer interviews.

EXHIBIT XIV-1

SPECIAL INFORMATION BOOKLET READERSHIP PERSONAL PLUS TELEPHONE INTERVIEWS

	NUMBER OF OBSERVATIONS	PERCENTAGE ESTIMATES	95% CONFIDENCE INTERVALS
READ ALL PARTS CAREFULLY	284 of 705	40.3%	40.3% ± 3.6%
READ SOME PARTS	327 of 705	46.4%	46.4% ± 3.7%
TOTAL READERSHIP	611 of 705	86.7%	86.7% ± 2.5%

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

The exhibit indicates that:

- Between 8 and 9 of every 10 home buyers who receive the SIB read it;
- Between 3 and 4 of every 10 home buyers who receive the SIB read all of it with care; and
- Between 4 and 5 of every 10 home buyers who receive the SIB read some parts of the booklet.

Characteristics Of Readership

The home buying readership of the HUD Special Information Booklet was segmented along three demographic dimensions:

- educational level;
- annual household income level; and
- age.

Exhibit XIV-2a presents a cross-tabulation of SIB readership and educational level.

The key findings from the display are:

- Among respondents who did not complete high school, the proportion who read all or part of the SIB is significantly less than this same proportion for other educational levels.
- There is no significant difference in readership levels among high school graduates, respondents who attended college, and respondents who attended post graduate school.

Exhibit XIV-2b presents data on readership and annual household income levels.

The key findings are:

- Among high income earners ($50,000 or more per year) the proportion who read all or part of the SIB is significantly less than the same proportions for income earners in the other catagories.
- There are no significant differences in the readership proportions among home buyers from the first four income categories.

EXHIBIT XIV-2

READERSHIP AND EDUCATION LEVEL

READERSHIP	LESS THAN HIGH SCHOOL	HIGH SCHOOL GRAD	COLLEGE	POST GRAD
COMBINED	70.6%	86.0%	86.4%	87.3%

(a)

READERSHIP AND INCOME LEVEL

READERSHIP	$5000-$9999	$10000-$14999	$15000 $24999	$25000-$34999	$35000-49,999	$750,000
COMBINED	84.6%	91.8%	89.2%	87.7%	85.0%	71.7%

(b)

READERSHIP AND AGE

TELEPHONE	< 25 YRS	25-34	35-44	45-54	≥55
COMBINED	86.6%	88.1%	84.1%	83.4%	84.0%

(c)

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

Finally Exhibit XIV-2 presents a cross-tabulation of readership with age. The data indicate that there are no significant differences in readership levels across age categories. That is, readership levels are not correlated with the age of the home buyer.

Summarizing the results on SIB readership:

- As a group, respondents who did not complete high school read the SIB least and significantly less than respondents in other education categories who tend to have similar readership rates.
- The highest income earners as a group read the booklet least of all six predefined income groups. The other income groups have higher and comparable readership rates.
- Readership levels do not significantly co-vary with the age of the home buyer.

SHOPPING FOR SETTLEMENT SERVICES

This section addresses two aspects of the issue of comparative shopping of settlement services by consumers.

- the extent and level of comparative shopping of settlement services by home buyers; and
- the demographic segmentation of shoppers.

The focus here is on shopping that home buyers, as opposed to home sellers, engage in. Therefore, we do not consider the shopping that home sellers do in selecting a real estate agent/broker. This emphasis follows the underlying rationale of the RESPA legislation, which attempts to place greater and more timely information in the hands of home buyers through the HUD Special Information Booklet and the lender's good faith estimates of settlement costs distributed during the time of loan application.

Shopping, as the term is used here, refers to the active consideration on the part of a home buyer of more than one provider in the rendering of a given settlement service. For example, a home buyer is said to have shopped for an attorney if he considered more than one attorney before hiring one.

The issue of shopping is at the heart of the RESPA legislation. Armed with greater and more timely information about the settlement process and the settlement provider, home buyers are expected to engage in greater amounts of comparative shopping. Higher levels of shopping exert downward pressure on the prices consumers are charged when less price-competitive providers are forced to reduce their prices in the face of slipping volumes as consumers migrate towards the more price-competitive suppliers of settlement services. For these reasons the discussion that follows is central in the evaluation of the effectiveness of RESPA.

Extent And Level Of Comparative Shopping

The extent and level of comparative shopping are captured in two displays. Exhibit XIV-3 indicates the proportion of total respondents who claimed they shopped for exactly one, exactly two, or exactly three providers of settlement services. The data indicate that:

- 31.5 percent of the respondents shopped for one provider
- 7.9 percent shopped for two providers;
- 0.2 percent shopped for three providers; and
- 39.6 percent engaged in some form of comparative shopping.

A 95 percent confidence interval for the total amount of shopping is 35.9 percent to 43.4 percent. That is, between 35 and 45 of every 100 homebuyers shopped for one or more settlement service providers.

Exhibit XIV-4 shows the proportion of respondents who shopped for a:

- lender;
- title insurance company; and
- attorney.

The proportions shown are computed using the pool of respondents who actually employed the given type of provider. That is, if 300 respondents hired an attorney and 30 shopped for an attorney, the proportion of shoppers is computed as 10 percent.

The combined statistics show that:

- 48.6 percent of the respondents shopped for a lender. This includes respondents who indicated that someone besides themselves shopped for a lender on their behalf. This latter quantity accounted for 13.8 percent of lender shopping.
- 14.0 percent of the respondents shopped for a title insurance company.
- 30.5 percent of the respondents shopped for an attorney.

EXHIBIT XIV-3

EXTENT OF SHOPPING

LEVEL OF SHOPPING	TELEPHONE	PERSONALS	COMBINED
NO SHOPPING	60.0%	60.8%	60.4%
EXACTLY ONE PROVIDER	29.1%	34.0%	31.5%
EXACTLY TWO PROVIDERS	10.6%	5.0%	7.9%
EXACTLY THREE PROVIDERS	0.3%	0.2%	0.2%
TOTAL SHOPPING	40.0%	39.2%	39.6%

(a)

EXHIBIT XIV-4

SHOPPING FOR SPECIFIC PROVIDERS

	LENDERS[1]	TITLE COS.	ATTORNEYS
TELEPHONE	46.7	11.1%	17.9%
PERSONAL	50.6	18.8%	33.1%
COMBINED	48.6%	14.0%	30.5%

(b)

[1] Lender percentages include those respondents who claimed that some party other than themselves shopped for a lender for them.

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

Demographics Of Shoppers

Shoppers of settlement services were disaggregated along three demographic dimensions to identify underlying differences within each group of shoppers. The three demographic dimensions examined are educational level; annual household income and age.

Exhibit XIV-5a presents a cross tabulation of shoppers with their educational level.

The key finding is that respondents who completed some college and/or post graduate education shopped significantly more than those with lesser amounts of education. The extent of shopping does not differ significantly among the two college educated groups. The differences in shopping levels between high school graduates and those who did not complete high school are also insignificant.

Exhibit XIV-5b gives shopping levels for six income groupings. "Income" here refers to annual household income that is the combined annual household income when there is more than one income earner in a family.

A review of the table's bottom row yields the following key findings:

- Low income earners (less than $15,000 annual income) shop significantly less than moderate and high income earners ($15,000 or more).

- Shopping levels for the moderate-to-high income earners are not significantly related to the level of income within these groups. That is, although the data appear to suggest that among the moderate-to-high income earners shopping levels increase with income, there are in fact no significant differences in the proportion of respondents in these groups who shop.

Exhibit XIV-5c gives shopping levels for five age categories.

The data indicate that nearly all age groups engage in approximately the same amount of comparative shopping. The exception is home buyers 55 and older; the proportion of these respondents who shop is significantly less than the four younger home buying groups.

A summary of the results of this demographic analysis of shopping behavior is as follows:

- Homebuyers with some college or post-graduate training do more shopping than home buyers with less education.

EXHIBIT XIV-5

SHOPPING AND EDUCATIONAL LEVEL

SHOPPERS	LESS THAN HIGH SCHOOL	HIGH SCHOOL	COLLEGE	POST GRAD
TELEPHONE	31.0%	36.5%	40.4%	46.2%
PERSONALS	29.0%	25.2%	61.2%	50.0%
COMBINED	30.2%	31.5%	50.2%	48.4%

(a)

SHOPPING AND INCOME

SHOPPERS	5000-9999	10000-14999	15000-24999	25000 34999	35000 49999	≥ 50000
COMBINED	30.0%	25.6%	39.3%	40.3%	46.4%	47.8%

(b)

SHOPPING AND AGE

SHOPPERS	< 25	25-34	35-44	45-54	≥ 55
TELEPHONE	36.6%	42.3%	40.0%	40.7%	18.2%
PERSONALS	33.3%	39.9%	40.0%	43.2%	31.4%
COMBINED	35.2%	41.2%	40.0%	42.1%	25.0%

(c)

SOURCE: PMM&CO. Home Buyer Survey, February 1980.

- Moderate and high income earners do more shopping than low income earners.

- Older home buyers (55 and older) do significantly less shopping than younger home buyers.

Together these findings suggest that younger, well-educated, moderate-to-high income earners engage in the greatest amounts of comparative shopping for settlement services.

EXTENT OF SHOPPING DIRECTLY ATTRIBUTABLE TO RESPA

Calculations were made as to the proportion of home buyers who were influenced to shop by RESPA. That is, we calculated the proportion of consumers who shopped for settlement services but would not have shopped were there no RESPA. In so doing, we ascertain a lower bound on the marginal effect of RESPA in increasing the pool of settlement service shoppers.

The model shown in Exhibit XIV-6 was employed in estimating this RESPA effect. It consists of three components:

- the proportion of all homebuyers who received the HUD Special Information Booklet (SIB);

- the proportion of those homebuyers who read the HUD Special Information Booklet; and

- the proportion of the group of readers who claimed they were influenced to shop for settlement services as a result of their reading the HUD SIB.

Exhibit XIV-6 displays the results of RESPA's effect on shopping.

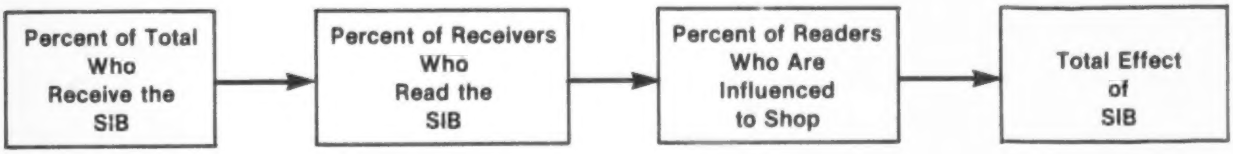
The data indicate that more than 56 percent (705 of 1247) of the respondents claimed they received the SIB. Of this group 87 percent (611 of 699) indicated they read some parts or all of the booklet. Almost 19 percent of these readers (113 or 607) responded that they were influenced to shop by reading the SIB. The estimate of RESPA's total effect is 9.2 percent. A 95 percent confidence interval for this estimate is 7.6 percent to 10.8 percent.

This interval estimate suggests that between 7 and 11 of every 100 homebuyers are influenced to shop for settlement services as a result of RESPA.

This, of course, is a lower bound on RESPA's influence on shopping behavior because it considers only those consumers who claim they were directly moved to shop because of reading the HUD SIB. Other home buyers (and home sellers) may have heard about RESPA and shopped without consulting the SIB. No attempt is made to calculate these secondary effects.

EXHIBIT XIV-6

COMPUTATION OF RESPA EFFECT ON CONSUMER SHOPPING


Percent of Total Who Receive the SIB
Percent of Receivers Who Read the SIB
Percent of Readers Who Are Influenced to Shop
Total Effect of SIB

Receiver % X Reader % X Influenced % = Total Effect

SOURCE: PMM&CO., 1980.

It could be argued that these estimates of RESPA's total effect on shopping may seriously understate RESPA's true influence. Home buyers who have purchased a home before may have learned that prices are not perfectly uniform and that by shopping they could perhaps realize substantial savings. Clearly RESPA could not be attributed to influencing the decision of these homebuyers to shop for settlement services associated with the purchase of their most recent home.

However, any knowledge of RESPA gained from a previous transaction or simply through word of mouth may have influenced to some extent a consumer's decision to shop in his most recent transaction. The data do not allow us to compute this quantity, nor do we have any clear conception of its magnitude. Nevertheless, this reasoning suggests that the estimates computed in this section must be regarded as lower bounds on the total effect of RESPA.

CONCLUSIONS

Changes in the behavior of consumers of settlement services since RESPA were examined by focusing on three areas:

- the extent and demographic characteristics of the readership of the HUD Special Information Booklet;
- the extent and demographic characteristics of consumers who shop for settlement services; and
- the degree to which RESPA has influenced consumers to engage in active comparative shopping among the providers of settlement services.

Key findings include:

- Home buyers who receive the HUD SIB typically read all or at least some portions of it. Between 8 and 9 of every 10 home buyers who receive the HUD SIB read it.
- Moderate income earners with a high school diploma or more have the highest readership rates.
- Between 3 and 5 of every 10 home buyers engage in some form of comparative shopping among settlement service providers. Consumer shopping is greatest in the case of selecting a lender. Approximately 40 percent of the home buyers indicated that they or some outside party acting on their behalf considered more than one lender before deciding on one.
- Young, well educated, moderate-to-high income earners engage in the greatest amounts of comparative shopping.
- The RESPA provisions induce at least 1 of every 10 home buyers to engage in some degree of comparative shopping among settlement service providers

- Young, well educated, moderate-to-high income earners engage in the greatest amounts of comparative shopping.

- The RESPA provisions induce at least 1 of every 10 home buyers to engage in some degree of comparative shopping among settlement service providers

XV. PRICE IMPACT

RESPA was intended to reduce the need for referrals by making settlement service markets more price competitive. Increased consumer shopping, it is believed, enables consumers to identify more price competitive providers. RESPA's proponents contend that the Act facilitates comparative shopping by (1) arming consumers with greater and more timely information about the settlement process, settlement practices, and settlement providers; and (2) encouraging consumers to shop among the providers of settlement services. As consumers migrate toward more price competitive providers, less competitive providers are forced to reduce the prices they charge or face continually declining business volume. As these less competitive providers adjust their prices downward, they make the settlement service market more price competitive.

Isolating and determining RESPA's marginal impact on settlement service prices and therefore its influence on the price competitiveness of these markets, is a difficult if not impossible task. Other factors besides RESPA have been operating in the settlement service markets since the legislation's inception. These include:

- inflation;
- other related federal legislation and regulation;
- state legislation and regulation;
- court decisions;
- technology improvements; and
- major industry trends.

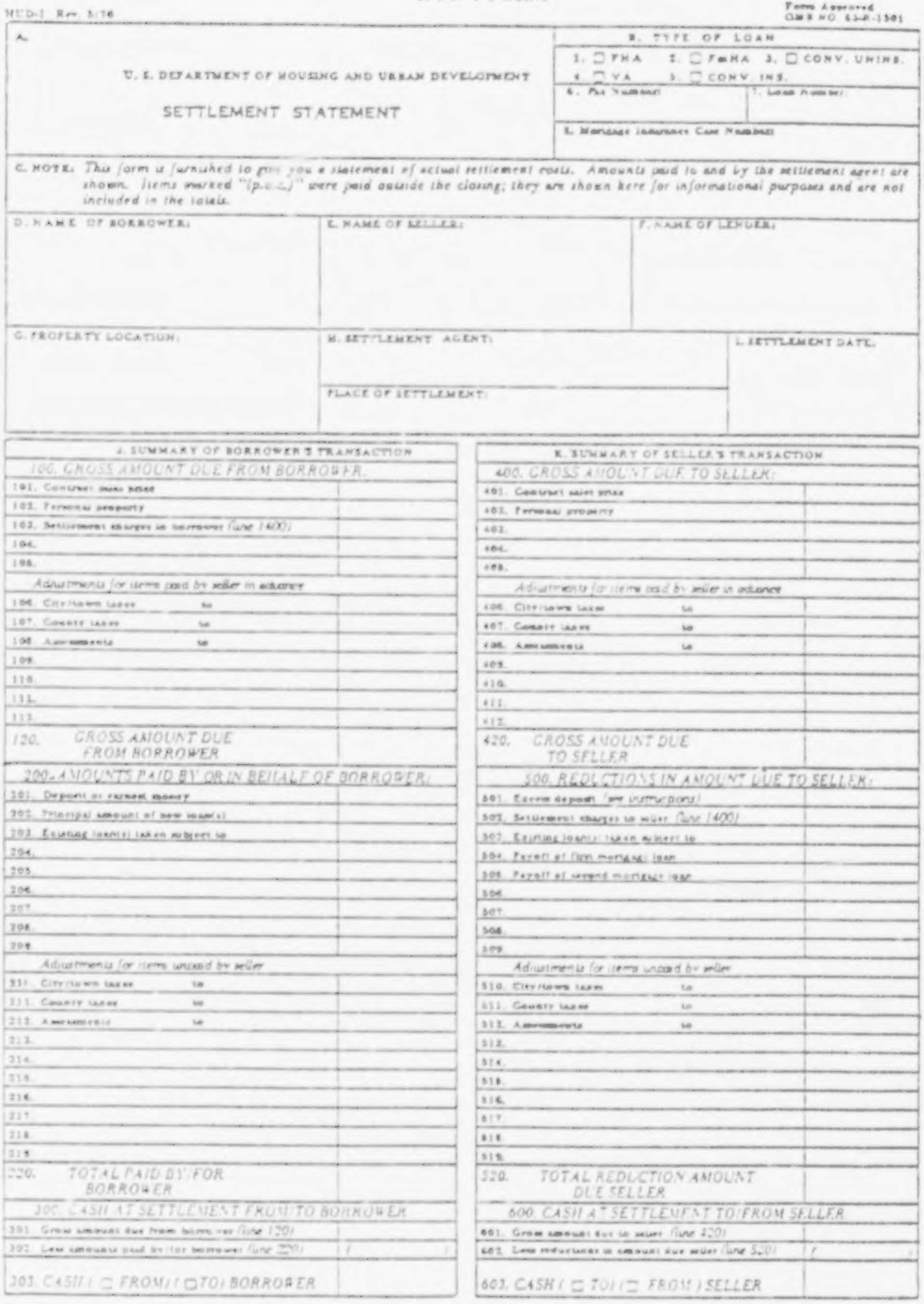
No rigorous, objective, quantitative method exists for determining how much each factor is responsible for price changes. Therefore, we have focused on determining to what extent prices have changed since RESPA, irrespective of the sources of the changes. In addition to determining whether prices have changed, we also discuss:

- the distribution of changes across cost types (lender charges, title charges, etc.);
- the direction of these changes; and
- the magnitude of the changes.

The primary data sources for examining price changes are the surveys of Uniform Settlement Statements (HUD-1s) completed in 1975 (by HUD) and in 1979 (by PMM&Co.). The HUD-1 is intended to identify the specific settlement services rendered in connection with a closing and the prices the borrower and the seller pay for these services. A copy of the HUD-1 appears as Exhibit XV-1.

EXHIBIT XV-1

HUD-1 FORM



HUD-1 Rev. 5/76

Form Approved
OMB NO. 63-R-1501

A. U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT SETTLEMENT STATEMENT	B. TYPE OF LOAN 1. ☐ FHA 2. ☐ FmHA 3. ☐ CONV. UNINS. 4. ☐ VA 5. ☐ CONV. INS. 6. File Number: 7. Loan Number: 8. Mortgage Insurance Case Number:

C. NOTE: *This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.*

D. NAME OF BORROWER:	E. NAME OF SELLER:	F. NAME OF LENDER:
G. PROPERTY LOCATION:	H. SETTLEMENT AGENT: PLACE OF SETTLEMENT:	I. SETTLEMENT DATE:

J. SUMMARY OF BORROWER'S TRANSACTION	
100. GROSS AMOUNT DUE FROM BORROWER:	
101. Contract sales price	
102. Personal property	
103. Settlement charges to borrower *(line 1400)*	
104.	
105.	
Adjustments for items paid by seller in advance	
106. City/town taxes to	
107. County taxes to	
108. Assessments to	
109.	
110.	
111.	
112.	
120. GROSS AMOUNT DUE FROM BORROWER	
200. AMOUNTS PAID BY OR IN BEHALF OF BORROWER:	
201. Deposit or earnest money	
202. Principal amount of new loan(s)	
203. Existing loan(s) taken subject to	
204.	
205.	
206.	
207.	
208.	
209.	
Adjustments for items unpaid by seller	
210. City/town taxes to	
211. County taxes to	
212. Assessments to	
213.	
214.	
215.	
216.	
217.	
218.	
219.	
220. TOTAL PAID BY/FOR BORROWER	
300. CASH AT SETTLEMENT FROM/TO BORROWER	
301. Gross amount due from borrower *(line 120)*	
302. Less amounts paid by/for borrower *(line 220)*	( )
303. CASH (☐ FROM) (☐ TO) BORROWER	

K. SUMMARY OF SELLER'S TRANSACTION	
400. GROSS AMOUNT DUE TO SELLER:	
401. Contract sales price	
402. Personal property	
403.	
404.	
405.	
Adjustments for items paid by seller in advance	
406. City/town taxes to	
407. County taxes to	
408. Assessments to	
409.	
410.	
411.	
412.	
420. GROSS AMOUNT DUE TO SELLER	
500. REDUCTIONS IN AMOUNT DUE TO SELLER:	
501. Excess deposit *(see instructions)*	
502. Settlement charges to seller *(line 1400)*	
503. Existing loan(s) taken subject to	
504. Payoff of first mortgage loan	
505. Payoff of second mortgage loan	
506.	
507.	
508.	
509.	
Adjustments for items unpaid by seller	
510. City/town taxes to	
511. County taxes to	
512. Assessments to	
513.	
514.	
515.	
516.	
517.	
518.	
519.	
520. TOTAL REDUCTION AMOUNT DUE SELLER	
600. CASH AT SETTLEMENT TO/FROM SELLER	
601. Gross amount due to seller *(line 420)*	
602. Less reductions in amount due seller *(line 520)*	( )
603. CASH (☐ TO) (☐ FROM) SELLER	

EXHIBIT XV-1 (Continued)

-2-

L. SETTLEMENT CHARGES

700. TOTAL SALES/BROKER'S COMMISSION based on price $ @ % =	PAID FROM BORROWER'S FUNDS AT SETTLEMENT	PAID FROM SELLER'S FUNDS AT SETTLEMENT
Division of Commission (line 700) as follows:		
701. $ to		
702. $ to		
703. Commission paid at Settlement		
704.		
800. ITEMS PAYABLE IN CONNECTION WITH LOAN		
801. Loan Origination Fee %		
802. Loan Discount %		
803. Appraisal Fee to		
804. Credit Report to		
805. Lender's Inspection Fee		
806. Mortgage Insurance Application Fee to		
807. Assumption Fee		
808.		
809.		
810.		
811.		
900. ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE		
901. Interest from to @ $ /day		
902. Mortgage Insurance Premium for months to		
903. Hazard Insurance Premium for years to		
904. years to		
905.		
1000. RESERVES DEPOSITED WITH LENDER		
1001. Hazard insurance months @ $ per month		▨
1002. Mortgage insurance months @ $ per month		▨
1003. City property taxes months @ $ per month		▨
1004. County property taxes months @ $ per month		▨
1005. Annual assessments months @ $ per month		▨
1006. months @ $ per month		▨
1007. months @ $ per month		▨
1008. months @ $ per month		▨
1100. TITLE CHARGES		
1101. Settlement or closing fee to		
1102. Abstract or title search to		
1103. Title examination to		
1104. Title insurance binder to		
1105. Document preparation to		
1106. Notary fees to		
1107. Attorney's fees to		
(includes above items numbers:	▨	▨
1108. Title insurance to		
(includes above items numbers:	▨	▨
1109. Lender's coverage $	▨	▨
1110. Owner's coverage $	▨	▨
1111.		
1112.		
1113.		
1200. GOVERNMENT RECORDING AND TRANSFER CHARGES		
1201. Recording fees: Deed $; Mortgage $; Releases $		
1202. City/county tax/stamps: Deed $; Mortgage $		
1203. State tax/stamps: Deed $; Mortgage $		
1204.		
1205.		
1300. ADDITIONAL SETTLEMENT CHARGES		
1301. Survey to		
1302. Pest inspection to		
1303.		
1304.		
1305.		
1400. TOTAL SETTLEMENT CHARGES (enter on lines 103, Section J and 502, Section K)		

HUD-1 Rev. 5/76

This chapter is divided into four sections. The first section discusses the general characteristics of the 1979 HUD-1 survey. The second section presents the results of the current (1979) survey. A comparative analysis of the 1979 and 1975 HUD-1 data sets constitutes the third section. Concluding remarks on price impact close the chapter.

GENERAL CHARACTERISTICS OF THE 1979 HUD-1 SURVEY

This section presents a brief overview of the 1979 survey of HUD-1s conducted by PMM&Co. A more detailed discussion is included in the introductory chapter of Volume III of this report.

Survey Overview

The 1979 HUD-1 survey collected HUD-1 data from a stratified random sample of U.S. institutional lenders. Lenders were stratified along two dimensions: lender type and lender size. There are four types of institutional lenders:

- savings and loan institutions;
- commercial banks;
- mortgage companies; and
- mutual savings banks.

Lenders within each institutional type were divided into large (stratum I) and small (stratum II) lenders. Each large lender accounted for 10 percent or more of the loan origination activity for its geographic area.

Randomly selected lenders from each type and size category in each of the 50 states and eight standard metropolitan statistical areas were asked to submit HUD-1s. The SMSAs are:

- Boston, Massachusetts;
- Denver, Colorado;
- District of Columbia;
- Jacksonville, Florida;
- Los Angeles, California
- St. Louis, Missouri;
- San Antonio, Texas; and
- Seattle, Washington.

In order to derive reasonably reliable estimates of settlement costs, a threshold of at least 250 observations per state and SMSA was specified. Oversampling by a factor of four allowed the study team to attain at least this number of observations for nearly all geographic groups. These thresholds; together with the expected level of loan origination activity for an area determined the number of "months' worth" of HUD-1s requested from lenders. The large majority of HUD-1s were records of closings between October 1978 and January 1979.

Potential Inaccuracies And Biases

It is important to note that although the HUD-1s are drawn from a representative sample of lender types, lender sizes and geographic areas, there is the potential that they contain certain biases and inaccuracies. In addition to the usual clerical and coding errors commonly encountered in survey sampling and normally of minimal importance, at least two other potential sources of error may tend to produce distorted estimates. The first involves the notion of construct validity; the second is self-selection bias.

Construct Validity

"Construct validity" refers to the extent to which the sampling instrument (in this case the HUD-1s) accurately reflects the variables the survey is attempting to measure (closing costs). It became clear through conversations with lenders and HUD personnel alike that there are considerable definitional and interpretive problems with the line items on the HUD-1s. For example, it is not altogether clear where particular costs are to be entered on the form, as local nomenclature may differ somewhat from that appearing on the form. Furthermore, total closing costs are often not fully disaggregated into their various component costs. Frequently, one type of cost is subsumed under and included within some other cost and it is difficult to separate such costs into their proper parts post hoc.

As settlement practices vary from area to area, so do filing practices. For example, banks in some areas do not always complete the forms, and there is no incentive to ensure that other providers have entered accurate data. Moreover, the study team learned that the interpretation of the line items varies not only from area to area but also within a given institution. That is, filers may file differently even within the same institution.

Self Selection Bias

In addition to the problems raised under construct validity, the representativeness of the sample of all transactions completed in the areas studied and within the timeframe specified may also be questioned due to self-selection biases. Although its influence cannot be determined accurately and precisely, non-respondent bias, that is, refusal by a selected lender to participate in the study, may obfuscate sample estimates. Thus, it is possible that the responses obtained may represent a different distribution of lender types than prevails generally in the housing markets studied.

Secondly, responding lenders may have engaged in some degree of self-selection of the forms they submitted. Although selected lenders were asked to send forms for all transactions closed during the test period(s), and most probably did so, there was no way to ensure that they did so without some kind of on-site check of the lender's files. For example, a particular lender might have eliminated some forms which showed that he charged unusually high settlement fees on the grounds that these forms would reflect adversely on him.[1]

Nonresponse and self-selection biases are therefore potential impediments to obtaining reliable estimates and they may be present in the 1979 HUD-1 data set. We suggest, therefore, that the estimates presented here be compared and used with care.

RESULTS OF THE 1979 SURVEY OF HUD-1s

This section presents estimates of average settlement costs by geographic area, price range, and cost class. Sample estimates are derived for three geographic groups:

- the nation;
- each state; and
- each of the eight SMSAs.

National Estimates

Exhibit XV-2 presents national averages for the following classes of settlement costs:

- Contract sales price;[2]
- Broker's commission percentage;
- Items payable in connection with the loan (Series 800);
- Items required by the lender to be paid in advance (Series 900);
- Reserves deposited with the lender (Series 1000);

---

[1] Because a limit of 250 forms from a given institution was specified, large lenders may have engaged in even more exaggerated forms of self-selection.

[2] Contract sales price is not a settlement cost. It is included here for normalizing settlement changes across geographic areas.

- Title charges (Series 1100);
- Government recording and transfer charges (Series 1200);
- Additional settlement charges (Series 1300);
- Total settlement charges not including broker's commission;[1] and
- Total settlement charges not including broker's commission and taxes.[2]

The estimates include charges to both the home buyer and home seller. Estimates are computed using only nonzero HUD-1 entries. That is, the number of observations used in computing sample means and standard deviations is the number of nonzero costs appearing on the HUD-1 for the given class of cost. For example, suppose only 1,000 of the some 18,000 HUD-1s contain a broker's commission; then the sample mean and standard deviation for broker's commission would be computed using an N (the number of observations) of 1,000, not 18,000. This implies, of course, that summing the averages of the component settlement costs will overstate average total settlement costs. That is, the sum of the average component costs will not equal the average total settlement costs. The alternative, however, of including zero costs in the averages is less attractive as it results in seriously understated average component settlement charges. Estimates are derived after removing all "outliers" beyond four standard deviations from the mean.

The national estimates are computed using the full set of HUD-1 data, which includes all the state and SMSA data. No attempt was made to precisely weigh the observations of a given state based on the state's share of the nation's aggregate level of origination activity, as these data were not readily available. Rather, the estimates reflect essentially equal weightings of each state supplemented by the data from the SMSAs. The estimates presented, threfore, are not true national estimates but an approximation of those estimates.

A review of Exhibit XV-2 yields the following key findings:

- Average contract sales price for the national data set is $54,864.

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[1] Broker fees are not included in total settlement charges for two reasons: (1) wide variation across geographic units in the incidences with which these fees are recorded on the HUD-1 may distort the resultant estimates; (2) broker fees are very large relative to other settlement charges and they would therefore swamp individual settlement costs if included in the totals.

[2] Taxes include all government recording and transfer charges and all state and local taxes.

EXHIBIT XV-2

SETTLEMENT COSTS
NATIONAL STATISTICS

Full Survey

Cost Item	N	Mean ($) or %	Std. Error
1. Contract Sales Price	17,968	54,864	252
2. Broker's Commission %	5,631	5.8	<.12
3. Items Paid in Connection w/Loan	16,822	975	6
4. Items Required by Lender Paid in Advance	13,472	318	2
5. Reserves Deposited with Lenders	12,303	211	2
6. Title Charges	17,835	389	2
7. Government Recording and Transfer	17,907	253	3
8. Additional Settlement Costs	8,210	104	2
9. Total Settlement Costs Less Broker Fees[1]	17,968	2,030	9
10. Line Item 9 Less Taxes[2]	17,968	1,657	8
11. Line Item 9 Line Item 1[3]	17,968	4.2	<.1
12. Line Item 10 Line Item 1[4]	17,968	3.5	<.1

Source: 1979 HUD-1 Survey

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[1] For each HUD-1 total settlement charges less broker fees were computed by summing all individual settlement charges for both buyer and seller and not including brokerage fees. These quantities were then averaged yielding the figures given in line 9.

[2] For each HUD-1 individual settlement charges for both buyer and seller not including broker fees and taxes (HUD-1 line items 1003, 1004, 1202, 1203 and other taxes line items) were summed and the resulting quantities averaged yielding the figures in line 10.

[3] The quantities computed in the first footnote for each HUD-1 were divided by the HUD-1's respective contract sales price. These quantities were averaged giving the figures in line 11 (total settlement charges less broker fees as a percentage of contract sales price).

[4] The quantities computed in the second footnote for each HUD-1 were divided by the HUD-1's respective contract sales price. These quantities were averaged giving the figures in line 12 (total settlement charges less broker fees and taxes as a percentage of contract sales price).

- Items paid in connection with the loan constitute the most expensive settlement cost class, aside from brokerage fees, with an average of $975 or 48 percent of total settlement changes; title charges make up a distant second at $389, (19 percent) followed by items required by the lender to be paid in advance at $318, (16 percent) and government recording and transfer charges at $253, (12 percent).

- Total settlement charges to the buyer and seller, not including brokerage fees, averaged $2,030 or 4.2 percent of contract sales price.

- Total settlement charges to the buyer and seller, less brokerage fees and state and local taxes, averaged $1,657 or 3.5 percent of contract sales price.

State Estimates

Exhibit XV-3 gives state averages for the ten classes of settlement charges identified in the national display of settlement costs. These estimates include charges to both buyers and sellers. Estimates for each state are computed as in the case of the national estimates.

The key findings from Exhibit XV-3 are:

- Items paid in connection with the loan, in the majority of states, make up the largest proportion of total settlement costs.

- Title charges, in most states, make up the second largest proportion of total settlement charges.

- Items required by the lender to be paid in advance constitute the third largest settlement cost for most states.

- Reserves or government recording and transfer charges constitute the fourth largest portion of total settelement costs.

- Total settlement charges, not including broker fees, range from a low of 1.6 percent of contract sales price in Iowa and Louisiana to a high of 6.8 percent of contract sales price in Oklahoma, with an averall average of 4.1 percent.

- Total settlement charges, less broker fees and taxes ranged from a low of 1.2 percent of sales price in Vermont to a high of 6.3 percent in Oklahoma and Mississippi with an overall average of 3.5 percent.

EXHIBIT XV-3

STATE STATISTICS

COST ITEMS	ALABAMA			ALASKA			ARIZONA			ARKANSAS			CALIFORNIA		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	352	39371	1035	301	84381	1661	280	49354	1420	292	40001	1292	273	80296	2552
2. Broker's Commission Rate	201	5.8	10	165	5.1	0.1	87	5.9	0.1	150	5.6	0.1	105	5.5	0.1
3. Items Paid in Connection w/Loan	347	1414	33	298	1184	38	278	1351	85	265	752	35	273	1508	87
4. Items Required by Lender in Advance	326	278	11	296	968	23	272	286	13	219	380	77	244	447	20
5. Reserves Deposited w/Lender	325	91	3	290	504	20	251	107	7	200	180	11	128	184	12
6. Title Charges	350	362	10	298	570	8	279	464	14	290	261	10	276	643	15
7. Government Recording and Transfer	351	141	6	299	73	6	274	48	6	292	107	7	273	204	15
8. Additional Settlement Costs	294	113	5	97	128	7	61	71	17	161	115	6	158	275	50
9. Total Settlement Costs Less Broker Fees	352	2360	45	300	3340	57	280	2333	54	292	1446	54	273	2971	79
10. Line Item 9 Less Taxes	352	2168	41	299	2855	47	280	2225	52	291	1241	48	273	2712	74
11. Line Item 9 ÷ Line Item 1	352	6.5	1	300	4.3	0.2	280	5.2	0.1	292	4.0	0.1	273	4.3	0.1
12. Line Item 10 ÷ Line Item 1	352	6.0	1	299	3.7	0.2	280	4.9	0.1	291	3.5	0.1	273	3.9	0.1

COST ITEMS	COLORADO			CONNECTICUT			DELAWARE			FLORIDA			GEORGIA		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	72	68874	3760	292	71813	3743	297	54481	1549	206	42671	1509	291	48387	1408
2. Broker's Commission Rate	36	6.1	0.2	170	5.7	0.1	185	6.5	0.1	54	5.6	0.2	131	5.5	0.1
3. Items Paid in Connection w/Loan	71	1062	77	257	548	33	171	501	53	203	1041	45	278	1778	62
4. Items Required by Lender in Advance	62	381	33	242	299	23	288	332	22	182	333	40	255	425	21
5. Reserves Deposited w/Lender	34	93	24	213	248	14	188	302	12	185	173	12	196	276	14
6. Title Charges	72	233	9	287	643	20	297	639	14	205	419	32	287	404	10
7. Government Recording and Transfer	72	159	32	292	212	18	297	1118	36	206	380	34	291	199	6
8. Additional Settlement Costs	50	45	3	78	144	19	270	129	6	75	134	15	174	134	35
9. Total Settlement Costs Less Broker Fees	72	1850	99	292	1784	62	297	2641	65	206	2311	76	291	2925	91
10. Line Item 9 Less Taxes	72	1663	93	290	1418	53	297	1345	46	206	1826	65	290	2576	81
11. Line Item 9 ÷ Line Item 1	72	2.9	0.2	292	3.1	0.1	297	5.3	0.1	206	5.9	0.2	291	6.3	0.2
12. Line Item 10 ÷ Line Item 1	72	2.6	0.1	290	2.5	0.1	297	2.8	0.1	2	4.7	0.2	290	5.5	0.2

NOTE: States in which the eight local market studies were conducted do not include the SMSA HUD-1 data.

SOURCE: PMM&CO. HUD-1 Survey, 1979.

EXHIBIT XV-3 (Continued)

COST ITEMS	HAWAII			IDAHO			ILLINOIS			INDIANA			IOWA		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	254	90051	2786	266	58445	1518	271	65961	2723	288	43732	1644	171	45574	1772
2. Broker's Commission Rate	107	5.4	0.2	149	5.6	0.1	82	6.2	0.1	189	6.4	0.1	66	6.2	0.1
3. Items Paid in Connection w/Loan	242	1801	307	266	1003	31	265	1081	47	277	818	38	127	431	161
4. Items Required by Lender in Advance	125	574	79	159	243	14	182	262	18	222	291	15	52	262	38
5. Reserves Deposited w/Lender	141	517	39	249	190	12	187	574	41	174	143	7	22	128	31
6. Title Charges	254	601	20	266	408	11	270	374	20	288	271	9	162	220	8
7. Government Recording and Transfer	254	157	9	264	72	11	270	119	10	285	24	3	171	87	7
8. Additional Settlement Costs	45	126	37	9	68	45	96	106	8	187	64	3	20	59	18
9. Total Settlement Costs Less Broker Fees	254	2469	82	266	1820	42	271	2176	71	288	1443	54	171	602	37
10. Line Item 9 Less Taxes	254	2249	77	266	1603	36	271	1676	56	288	1355	51	170	508	37
11. Line Item 9 – Line Item 1	254	3.0	0.1	266	3.6	0.1	271	4.1	0.2	288	4.1	0.2	171	1.6	0.1
12. Line Item 10 – Line Item 1	254	2.7	0.1	266	3.2	0.1	271	3.3	0.1	288	3.8	0.2	170	1.4	0.1

	KANSAS			KENTUCKY			LOUISIANA			MAINE			MARYLAND		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	506	51586	1368	284	43891	1531	235	51942	1422	288	40274.1	1525.4	259	55511	1900
2. Broker's Commission Rate	318	6.1	0.1	129	5.9	0.1	104	5.4	0.1	175	6.2	.11	162	6.1	.10
3. Items Paid in Connection w/Loan	493	570	17	253	624	38	234	1500	68	288	408	15	259	313	43
4. Items Required by Lender in Advance	381	382	18	171	208	16	231	401	18	288	133.2	10	259	181	15.4
5. Reserves Deposited w/Lender	397	101	5	108	141	12	212	95	11	288	124	10.3	259	431.2	23.1
6. Title Charges	494	253	5	276	208	8	234	513	13	288	250.4	7	259	515	12.0
7. Government Recording and Transfer	506	142	8	284	66	3	234	72	5	268	75	4.3	257	949	41
8. Additional Settlement Costs	191	92	9	37	92	23	194	97	5	288	6	2.2	259	74	5
9. Total Settlement Costs Less Broker Fees	506	1357	32	284	1006	43	235	2629	73	288	996	29.4	259	2569	76
10. Line Item 9 Less Taxes	506	1160	28	281	901	40	235	2514	71	287	824	24	259	1217	51
11. Line Item 9 – Line Item 1	506	3.1	0.1	284	2.6	0.1	235	5.6	0.2	288	3.0	.1	259	5.3	.2
12. Line Item 10 – Line Item 1	506	2.7	0.1	281	2.4	0.1	235	5.3	0.1	287	2.5	.1	259	2.7	.1

NOTE: States in which the eight local market studies were conducted do not include the SMSA HUD-1 data.

EXHIBIT XV-3 (Continued)

COST ITEMS	MASSACHUSETTS			MICHIGAN			MINNESOTA			MISSISSIPPI			MISSOURI		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	190	46796.3	1738.3	212	52547	2097.2	253	57165.0	1474.4	106	39647	1686.1	118	54274.0	2630
2. Broker's Commission Rate	77	6	.10	65	6.4	.12	136	5.7	.17	66	5.5	.12	34	6.1	.21
3. Items Paid in Connection w/Loan	190	138	20.2	212	278.1	23.0	253	974	54	106	1494	86	118	428.0	41.1
4. Items Required by Lender in Advance	150	69	9.3	212	179.2	12.2	253	235	21	106	372.2	25	118	51.3	8.2
5. Reserves Deposited w/Lender	190	237.1	16.3	212	206.3	14.0	253	128.1	11.1	106	103	11	118	63.3	8
6. Title Charges	190	411	13	212	327	12	253	306.3	11	106	385	17	118	269.3	12.2
7. Government Recording and Transfer	190	138.3	5	212	216.4	26.0	253	227.4	9.3	106	50	10	118	19.2	2.6
8. Additional Settlement Costs	190	29.2	2.7	212	57	8.0	253	39	13.4	106	91	9	118	50.0	14.1
9. Total Settlement Costs Less Broker Fees	190	1023	32.2	212	1367.4	41.1	253	1954	70.3	106	2511.2	115	118	886.4	57
10. Line Item 9 Less Taxes	188	658.3	24.2	212	952	28.3	253	1625.2	65.0	106	2408	110.3	118	810	54.2
11. Line Item 9 – Line Item 1	190	2.5	.1	212	3.3	1	253	3.8	.2	106	6.6	.2	118	2.2	1
12. Line Item 10 – Line Item 1	188	1.6	.1	212	2.3	1	253	3.2	.2	106	6.3	.2	118	2.0	1

COST ITEMS	MONTANA			NEBRASKA			NEVADA			NEW HAMPSHIRE			NEW JERSEY		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	282	56307	1967	290	42765.0	1214.3	131	65996	2322.3	309	49664.0	1417	297	64075.0	2001.2
2. Broker's Commission Rate	167	6.2	.07	83	6.0	.12	40	4.1	.33	148	6.7	.12	135	6.1	.1
3. Items Paid in Connection w/Loan	282	1133.3	47.0	290	1049	43.4	131	1471	64	309	439	29	297	443	45
4. Items Required by Lender in Advance	282	99.1	8.2	290	219.4	12.0	131	441	24.4	309	68.0	7.3	297	206	12.0
5. Reserves Deposited w/Lender	282	94	10.2	290	111.0	10	131	360.3	25	309	49.2	5.6	297	219.2	12.1
6. Title Charges	282	276.2	7.4	290	136	4.0	131	456.0	14	309	232.0	10	297	764	19
7. Government Recording and Transfer	282	54.0	7.8	290	146.4	17.0	131	141.4	14	309	152.2	7	297	510	34.1
8. Additional Settlement Costs	282	20	2.1	290	41.0	13	131	3	1.3	309	2	1	297	103	6.1
9. Total Settlement Costs Less Broker Fees	282	1761	54.3	290	1708	55.1	131	2890	83	309	943	39.2	297	2279	66
10. Line Item 9 Less Taxes	282	1630	54.3	290	1469	50.4	131	2437.4	74.1	309	743.2	34	297	1571	53.4
11. Line Item 9 – Line Item 1	282	3.8	.1	290	4.5	.1	131	4.8	.2	309	2.1	.1	297	4.2	.2
12. Line Item 10 – Line Item 1	282	3.5	.1	290	3.8	.1	131	4.1	.2	309	1.7	.1	297	3.0	.1

NOTE: States in which the eight local market studies were conducted do not include the SMSA HUD 1 data.

EXHIBIT XV-3 (Continued)

COST ITEMS	NEW MEXICO			NEW YORK			NORTH CAROLINA			NORTH DAKOTA			OHIO		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	293	43935	1119.1	245	56203.0	1985.2	298	42728	1130.0	297	46929	1129	291	45664	1449
2. Broker's Commission Rate	165	5.7	.13	33	6.5	.1	154	5.7	.1	84	6.1	.10	166	6.3	.1
3. Items Paid in Connection w/Loan	293	926	27.1	245	279	34	298	934	43	297	905.0	48	291	955.4	48
4. Items Required by Lender in Advance	293	353	13	245	154	12	298	268	13	297	92.2	9	291	197.2	11.4
5. Reserves Deposited w/Lender	293	122.2	9	245	172	16.3	298	147.1	8.1	297	67.1	13	291	118.2	9
6. Title Charges	293	365.1	8.3	245	546.2	18	298	376	9.3	297	148.3	4	291	402.1	17
7. Government Recording and Transfer	293	118	28.1	245	690.0	33	298	117	9.3	297	178.3	20	291	97	7.0
8. Additional Settlement Costs	293	46.1	3.0	245	58.0	5.0	298	95	5	297	4	2	291	50.4	4.2
9. Total Settlement Costs Less Broker Fees	293	2027	48	245	2131.3	88	298	1949	59.3	297	1395	61	291	1842.2	62
10. Line Item 9 Less Taxes	293	1836.1	41	245	1279	90	298	1711.2	52	297	1163	49	291	1650.4	58
11. Line Item 9 ÷ Line Item 1	293	4.9	.1	245	4.3	.1	298	4.8	.1	297	3.3	.2	291	4.7	.2
12. Line Item 10 ÷ Line Item 1	293	4.5	.1	245	2.6	.1	298	4.4	.1	297	2.8	.1	291	4.2	.2

COST ITEMS	OKLAHOMA			OREGON			PENNSYLVANIA			RHODE ISLAND			SOUTH CAROLINA		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	150	39134	1382	232	58844	1807.0	265	50192	1673	296	49941.0	2579	290	45835.4	1428.2
2. Broker's Commission Rate	110	5.7	.12	86	6.1	.1	128	6.0	.1	113	5.7	.10	171	5.6	.1
3. Items Paid in Connection w/Loan	150	1343	48.1	232	879	43.3	265	670	44	296	371.2	17	290	1094.2	44.2
4. Items Required by Lender in Advance	150	380	18.1	232	226	15	268	210	12.1	296	83.1	7.2	290	300	13.4
5. Reserves Deposited w/Lender	150	136	8	232	155	11	265	259	18.2	296	230.1	14.4	290	108	5.3
6. Title Charges	150	340	6.4	232	451	13.3	265	548.2	20	296	403	10.4	290	439	18
7. Government Recording and Transfer	150	107.3	7	232	94	19.2	265	1144	52.3	296	147	10	290	192.2	8.2
8. Additional Settlement Costs	150	88	5	232	42.1	14.2	265	64.1	10.4	296	.4	.21	290	78	6
9. Total Settlement Costs Less Broker Fees	150	2393.2	56	232	1875.4	66.0	264	2924.1	86.2	295	1250	36	290	2213.0	61.0
10. Line Item 9 Less Taxes	150	2199	53	232	1648.4	56.4	264	1538.3	58.0	295	898	27	290	1949	57.2
11. Line Item 9 ÷ Line Item 1	150	6.8	.2	232	3.7	.2	264	6.6	.2	295	3.1	.1	290	5.5	.2
12. Line Item 10 ÷ Line Item 1	150	6.3	.2	232	3.2	.1	264	3.6	.1	295	2.2	.1	290	4.9	.1

NOTE: States in which the eight local market studies were conducted do not include the SMSA HUD-1 data.

EXHIBIT XV-3 (Continued)

COST ITEMS	SOUTH DAKOTA			TENNESSEE			TEXAS			UTAH			VERMONT		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	293	42970	1425.0	293	42924.4	1235.4	283	53249	1158	270	54297	1349.2	287	42249	1081
2. Broker's Commission Rate	117	5.7	.1	204	5.4	.1	156	5.1	.10	120	5.4	.1	146	6.2	.11
3. Items Paid in Connection w/Loan	293	659	29	293	1124	38	283	1131.0	60	270	1556	56	287	92	12
4. Items Required by Lender in Advance	293	114.3	12	293	307	13.3	283	398.2	20	270	263.1	9.4	287	39	6.2
5. Reserves Deposited w/Lender	293	62	9.2	293	143.1	6.1	283	85	7	270	141	7.1	287	34.1	12
6. Title Charges	293	179	4.1	293	390	10.1	283	463	10	270	340.2	6.6	287	286	14.1
7. Government Recording and Transfer	293	103.2	11.2	293	177.0	9	283	85	7.2	270	28.0	3.2	287	254	11
8. Additional Settlement Costs	293	17.2	1.4	293	87	5.1	283	64.4	4.3	270	7.4	2	287	3.4	3.3
9. Total Settlement Costs Less Broker Fees	293	1135	39	293	2248.1	57	281	2359.3	81	270	2382	59	287	707.3	30
10. Line Item 9 Less Taxes	293	975	35	293	1968	51	281	2221	78	270	2241.0	55	287	437	24.4
11. Line Item 9 – Line Item 1	293	3.0	.1	293	5.7	.1	281	5.0	.2	270	4.8	.1	287	1.9	.1
12. Line Item 10 – Line Item 1	293	2.5	.1	293	5.1	.1	281	4.7	.2	270	4.5	.1	277	1.2	.1

COST ITEMS	VIRGINIA			WASHINGTON			WEST VIRGINIA			WISCONSIN			WYOMING		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	292	68757.1	2414.1	266	64318.3	1768.3	218	44951.2	4605.0	307	51542	1303	325	59843.1	1184
2. Broker's Commission Rate	189	5.6	.1	211	5.8	.1	78	6.0	.13	166	5.7	.1	124	5.8	.1
3. Items Paid in Connection w/Loan	292	1423.4	69.1	266	1159.2	35.0	218	215	35	303	693	31	325	1085	51.1
4. Items Required by Lender in Advance	292	312	18	266	197	13	218	25	5.4	307	144.4	9.1	325	262.1	12
5. Reserves Deposited w/Lender	292	261.0	13.4	266	95.0	8.3	218	14	3.0	307	125.4	17	325	102.2	6.2
6. Title Charges	292	541	15	266	469.3	12	218	270.0	10	307	249.3	9.2	325	231	5
7. Government Recording and Transfer	292	526	26	266	709.0	21	218	149	8	307	95	13.0	325	48	5
8. Additional Settlement Costs	292	87.0	5	266	1.2	.1	218	17.3	4.4	307	16	4.1	325	40	4
9. Total Settlement Costs Less Broker Fees	292	3258.3	102.1	266	2838	70	218	689.2	48	307	1344.2	44	325	1783.2	55.4
10. Line Item 9 Less Taxes	292	2508	82	266	2054.0	51.4	216	534	44.0	306	1132.3	39.2	325	1660	54.3
11. Line Item 9 – Line Item 1	292	5.4	.2	266	4.7	.1	218	2.0	.1	307	3.1	.2	325	3.1	.1
12. Line Item 10 – Line Item 1	292	4.2	.2	266	3.5	.1	216	1.6	.1	306	2.6	.1	325	2.9	.1

NOTE: States in which the eight local market studies were conducted do not include the SMSA HUD-1 data.

As many of the charges covary with the contract sales price and since average contract sales prices differ across states, it is difficult to directly compare the settlement costs of one state with those of another. To facilitate state comparisons, average costs for a subset of the data are given in Exhibit XV-4. These estimates refer to average settlement costs for homes with a contract sales price of $45,000 to $50,000.[1]

One should be cautious in interpreting variation in settlement costs across geographic areas. Regarding costs paid in connection with the loan, which is usually the largest settlement cost, the largest element is often points, which is typically a substitute for higher interest rates. Some states have mortgage interest rate ceilings (usury laws) and during periods of high interest rates, the number of points charged may be as high as 8 or 9. Conversely, other states, such as Maryland, prohibit the charging of any points. For these reasons, settlement cost comparisons across sites must be made cautiously and care must be taken not to draw what may be completely erroneous conclusions concerning observed differences in costs.

A review of Exhibit XV-4 yields the following key findings:

- Items paid in connection with the loan constitute the most expensive class of settlement cost accounting for approximately 40 to 65 percent of total settlement costs, not including broker fees.
- Title charges in most states make up the second largest proportion of total settlement costs, followed by items required by the lender to be paid in advance and reserves and government recording and transfer charges.
- Total settlement charges, not including broker fees, ranged from a low of $792 or 1.7 percent of contract sales price in Vermont to $3,674 or 7.7 percent in Georgia with an average of 4.3 percent.
- Total settlement charges not including broker fees and taxes ranged from $679 or 1.0 percent of sales price in Vermont to $3,240 or 6.8 percent in Georgia, with an average of 3.6 percent.

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[1] The $45,000 to $50,000 range approximates the mode of the distribution of contract sales prices for the state data.

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EXHIBIT XV-4

STATE STATISTICS — $45,000 TO $50,000 RANGE

	ALABAMA			ALASKA			ARIZONA			ARKANSAS			CALIFORNIA		
COST ITEMS	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)
1 Contract Sales Price	35	47628	254	4	46750	1010	34	47054	248	32	47069	299	18	47369	446
2 Broker's Commission Rate	22	5.5	.3	1	6	0	9	5.9	.5	14	5	.3	7	6	0
3 Items Paid in Connection w/Loan	35	1063	107	4	792	56	34	1517	140	30	679	81	18	1836	223
4 Items Required by Lender in Advance	34	364	31	4	491	58	33	363	43	28	280	29	17	337	26
5 Reserves Deposited w/Lender	34	100	12	4	323	85	31	149	26	25	180	23	13	187	26
6 Title Charges	35	405	32	4	448	7	34	441	16	32	236	26	18	703	121
7 Government Recording and Transfer	35	143	17	4	46	11	33	30	10	32	158	35	18	142	43
8 Additional Settlement Costs	30	161	13	3	204	45	8	31	12	15	82	13	15	120	30
9 Total Settlement Costs Less Broker Fees	35	2718	117	4	2357	173	34	2619	147	32	1463	147	18	3269	279
10 Line Item 9 Less Taxes	35	2512	105	4	2023	190	34	2515	147	32	1192	121	18	3018	258
11 Line Item 9 – Line Item 1	35	5.7	.2	4	5.0	.3	34	5.6	.3	32	3.1	.2	18	6.9	.6
12 Line Item 10 – Line Item 1	35	5.3	.2	4	4.3	.4	34	5.3	.3	32	2.5	.3	18	6.3	.5

	COLORADO			CONNECTICUT			DELAWARE			FLORIDA			GEORGIA		
COST ITEMS	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)
1 Contract Sales Price	6	46411	461	28	47[illegible]	309	29	47006	312	17	46961	312	45	47445	225
2 Broker's Commission Rate	5	6	.2	18	5.6	.25	17	6.1	.3	3	5.7	1.3	26	5.1	.26
3 Items Paid in Connection w/Loan	6	752	54	26	425	51	28	1606	162	17	1287	161	45	2164	116
4 Items Required by Lender in Advance	6	227	65	23	278	40	28	297	42	15	271	39	43	585	47
5 Reserves Deposited w/Lender	3	30	4	22	203	41	21	299	27	16	201	33	40	279	28
6 Title Charges	6	221	31	28	600	39	29	609	28	17	762	326	44	424	14
7 Government Recording and Transfer	6	112	89	28	123	19	29	900	47	17	375	37	45	215	9
8 Additional Settlement Costs	5	43	3	11	129	31	28	143	20	6	142	34	30	96	22
9 Total Settlement Costs Less Broker Fees	6	1362	140	28	1566	105	29	2572	159	17	2671	202	45	3674	167
10 Line Item 9 Less Taxes	6	1250	87	28	1308	87	25	1467	152	17	2131	189	45	3240	140
11 Line Item 9 – Line Item 1	6	2.9	.3	28	3.3	.2	29	5.5	.3	17	5.7	.4	45	1.7	.3
12 Line Item 10 – Line Item 1	6	2.7	.2	28	2.8	.2	29	3.1	.2	17	4.6	.4	45	6.8	.3

SOURCE 1979 HUD 1 Survey

EXHIBIT XV-4 (Continued)

COST ITEMS	HAWAII			IDAHO			ILLINOIS			INDIANA			IOWA		
	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)
1. Contract Sales Price	12	47486	411	15	47607	381	17	46615	316	25	46822	310	10	47399	471
2. Broker's Commission Rate	4	4.3	1.1	5	6.2	.2	10	6.5	.4	16	6.4	.2	2	6	0
3. Items Paid in Connection w/Loan	12	857	122	15	930	217	16	1029	164	25	918	129	8	705	388
4. Items Required by Lender in Advance	5	183	29	7	223	53	15	249	47	17	369	58	3	123	46
5. Reserves Deposited w/Lender	6	118	34	14	148	38	11	444	57	14	146	19	3	64	25
6. Title Charges	12	564	68	15	321	16	17	335	38	25	290	16	8	210	23
7. Government Recording and Transfer	12	116	23	15	14	2	17	136	72	25	51	19	10	97	38
8. Additional Settlement Costs	3	39	7	N/A	N/A	N/A	9	68	13	15	58	6	1	86	0
9. Total Settlement Costs Less Broker Fees	12	1751	116	15	1508	235	17	2042	205	25	1644	193	10	892	322
10. Line Item 9 Less Taxes	12	1578	114	15	1386	233	17	1638	197	25	1534	172	10	796	326
11. Line Item 9 ÷ Line Item 1	12	3.7	.2	15	3.2	.5	17	4.4	.4	25	3.5	4	10	1.9	.7
12. Line Item 10 ÷ Line Item 1	12	3.3	.2	15	2.9	.5	17	3.5	.4	25	3.3	4	10	1.7	.7

COST ITEMS	KANSAS			KENTUCKY			LOUISIANA			MAINE			MARYLAND		
	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)
1. Contract Sales Price	38	47855	230	22	47257	380	29	47364	317	26	46998	297	25	47436	319
2. Broker's Commission Rate	29	6.3	.1	10	5.4	.5	13	5.5	.3	17	6	.3	16	6.2	.3
3. Items Paid in Connection w/Loan	37	511	22	20	768	131	29	1920	388	24	480	43	18	405	170
4. Items Required by Lender in Advance	27	551	86	14	226	31	29	451	46	13	325	67	12	750	491
5. Reserves Deposited w/Lender	33	76	6	9	121	30	24	90	19	11	338	48	20	433	56
6. Title Charges	38	281	10	22	181	22	28	480	29	26	247	21	25	493	23
7. Government Recording and Transfer	38	180	39	22	71	9	29	85	16	26	69	1	25	813	68
8. Additional Settlement Costs	16	41	17	2	20	0	28	82	10	2	140	100	15	91	9
9. Total Settlement Costs Less Broker Fees	38	1434	90	22	1152	155	29	2756	215	26	1075	110	25	2181	142
10. Line Item 9 Less Taxes	38	1210	81	22	1035	150	29	2645	206	26	891	88	25	1032	159
11. Line Item 9 ÷ Line Item 1	38	3.0	.2	22	2.4	.3	29	5.8	.4	26	2.3	2	25	4.6	3
12. Line Item 10 ÷ Line Item 1	38	2.5	.2	22	2.2	.3	29	5.6	.4	26	1.9	2	25	2.2	3

EXHIBIT XV-4 (Continued)

COST ITEMS	MASSACHUSETTS N	MASSACHUSETTS Mean ($ or %)	MASSACHUSETTS Std. Error ($ or %)	MICHIGAN N	MICHIGAN Mean ($ or %)	MICHIGAN Std. Error ($ or %)	MINNESOTA N	MINNESOTA Mean ($ or %)	MINNESOTA Std. Error ($ or %)	MISSISSIPPI N	MISSISSIPPI Mean ($ or %)	MISSISSIPPI Std. Error ($ or %)	MISSOURI N	MISSOURI Mean ($ or %)	MISSOURI Std. Error ($ or %)
1. Contract Sales Price	17	47250	325	20	47915	343	39	47189	240	10	47575	481	11	47658	446
2. Broker's Commission Rate	7	5.9	.3	6	5.8	.4	29	5.7	.3	7	5.1	.6	5	5.6	.2
3. Items Paid in Connection w/Loan	5	322	141	17	326	56	37	1206	150	10	1851	229	11	579	152
4. Items Required by Lender in Advance	7	129	46	17	220	33	28	347	66	10	495	57	4	166	47
5. Reserves Deposited w/Lender	14	310	56	15	382	45	28	158	14	10	81	12	7	121	29
6. Title Charges	17	450	24	20	325	31	39	317	30	10	550	22	11	307	14
7. Government Recording and Transfer	17	148	3	20	291	96	39	187	11	10	46	25	11	17	.7
8. Additional Settlement Costs	10	81	18	15	58	2	21	48	8	8	103	8	9	69	10
9. Total Settlement Costs Less Broker Fees	17	1055	81	20	1441	121	39	2066	184	10	3142	249	11	1096	191
10. Line Item 9 Less Taxes	17	679	81	20	950	83	39	1803	173	10	3061	235	11	1012	182
11. Line Item 9 ÷ Line Item 1	17	2.2	.2	20	3.0	.3	39	4.4	4	10	6.6	.5	11	2.3	.4
12. Line Item 10 ÷ Line Item 1	17	1.4	.1	20	2.0	.1	39	3.8	4	10	6.4	.5	11	2.1	4

COST ITEMS	MONTANA N	MONTANA Mean ($ or %)	MONTANA Std. Error ($ or %)	NEBRASKA N	NEBRASKA Mean ($ or %)	NEBRASKA Std. Error ($ or %)	NEVADA N	NEVADA Mean ($ or %)	NEVADA Std. Error ($ or %)	NEW HAMPSHIRE N	NEW HAMPSHIRE Mean ($ or %)	NEW HAMPSHIRE Std. Error ($ or %)	NEW JERSEY N	NEW JERSEY Mean ($ or %)	NEW JERSEY Std. Error ($ or %)
1. Contract Sales Price	36	47267	255	32	46924	242	19	47255	239	40	47123	260	24	47316	275
2. Broker's Commission Rate	18	6.5	.1	7	6	.2	7	3.4	1	21	6.3	.2	8	5875	.4
3. Items Paid in Connection w/Loan	36	1286	118	32	1556	151	19	1981	158	37	577	84	20	621	206
4. Items Required by Lender in Advance	28	163	22	30	380	63	19	343	27	18	271	24	18	342	40
5. Reserves Deposited w/Lender	19	173	11	27	85	25	19	285	39	20	145	17	19	159	20
6. Title Charges	36	271	40	31	142	5.4	19	353	21	40	244	27	24	699	63
7. Government Recording and Transfer	36	17	4	31	151	40	19	111	31	39	144	4	24	585	132
8. Additional Settlement Costs	18	39	3	10	26	3	1	10	0	1	90	0	19	138	19
9. Total Settlement Costs Less Broker Fees	36	1910	132	32	2284	180	19	3073	135	40	1115	101	24	2258	250
10. Line Item 9 Less Taxes	36	1819	133	32	2094	180	19	2751	145	40	903	96	24	1662	205
11. Line Item 9 ÷ Line Item 1	36	4.0	.3	32	4.9	.3	19	6.5	.3	40	2.4	.2	24	4.8	.5
12. Line Item 10 ÷ Line Item 1	36	3.9	.3	32	4.5	.3	19	5.8	.3	40	1.9	.2	24	3.5	.5

EXHIBIT XV-4 (Continued)

COST ITEMS	NEW MEXICO			NEW YORK			NORTH CAROLINA			NORTH DAKOTA			OHIO		
	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)
1 Contract Sales Price	35	47745	256	30	47193	238	22	47158	289	37	47219	250	25	48049	350
2 Broker's Commission Rate	18	5.7	5	4	6.5	.03	14	5.6	3	11	6.2	2	15	5.9	2
3 Items Paid in Connection w/Loan	34	1172	88	21	196	107	22	1236	185	37	1714	575	25	1549	201
4 Items Required by Lender in Advance	35	360	32	15	331	52	20	316	43	16	225	38	20	255	28
5 Reserves Deposited w/Lender	34	137	12	21	243	78	18	223	24	21	246	154	18	188	38
6 Title Charges	35	379	13	30	507	38	22	430	22	37	143	7	25	369	29
7 Government Recording and Transfer	35	53	9	30	614	70	22	170	43	37	199	42	25	89	12
8 Additional Settlement Costs	22	91	20	18	55	13	19	89	7	3	137	106	16	78	17
9 Total Settlement Costs Less Broker Fees	35	2252	113	30	1829	188	22	2415	235	37	1763	146	25	2429	247
10 Line Item 9 Less Taxes	35	2115	110	30	1065	134	22	2096	193	37	1440	123	25	2242	231
11 Line Item 9 - Line Item 1	35	4.7	.2	30	3.9	4	22	5.1	5	37	3.7	3	25	5.1	5
12 Line Item 10 - Line Item 1	35	4.4	2	30	2.3	3	22	4.5	4	37	3.1	3	25	4.7	5

COST ITEMS	OKLAHOMA			OREGON			PENNSYLVANIA			RHODE ISLAND			SOUTH CAROLINA		
	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)	N	Mean ($ or %)	Std Error ($ or %)
1 Contract Sales Price	13	47242	382	25	47712	299	19	46713	344	28	46909	231	20	47403	320
2 Broker's Commission Rate	10	4.6	5	10	5.9	2	10	6	4	10	4.5	5	10	5.4	4
3 Items Paid in Connection w/Loan	13	1623	204	25	868	98	18	795	179	28	411	33	20	1494	229
4 Items Required by Lender in Advance	13	455	60	17	214	39	16	217	59	11	240	45	20	360	44
5 Reserves Deposited w/Lender	13	155	20	19	222	23	14	405	64	20	479	47	16	199	20
6 Title Charges	13	340	13	25	375	17	18	557	41	28	413	25	19	505	87
7 Government Recording and Transfer	13	102	11	25	55	32	18	953	88	28	149	29	20	169	6
8 Additional Settlement Costs	12	55	8	4	32	4	11	80	13	28	.06	.005	12	115	16
9 Total Settlement Costs Less Broker Fees	13	2737	223	25	1694	130	18	2897	226	28	1409	98	20	2736	267
10 Line Item 9 Less Taxes	13	2535	215	25	1500	110	18	1690	228	28	936	66	20	2462	254
11 Line Item 9 - Line Item 1	13	5.8	5	25	3.5	3	18	6.2	5	28	3.0	2	20	5.8	6
12 Line Item 10 - Line Item 1	13	5.4	5	25	3.1	2	18	3.6	5	28	2.0	1	20	5.2	5

EXHIBIT XV-4 (Continued)

COST ITEMS	SOUTH DAKOTA			TENNESSEE			TEXAS			UTAH			VERMONT		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	30	46628	283	24	47908	305	37	47200.1	250	42	47137.4	106	33	47503	282
2. Broker's Commission Rate	11	5.2	.5	17	5.5	.2	21	4.9	.25	15	5.6	2	18	5.6	.31
3. Items Paid in Connection w/Loan	27	721	84	23	1401	140	37	1317.0	176	42	200.7	119	33	87	17
4. Items Required by Lender in Advance	23	158	28	22	443	41	37	384	42	42	244.1	20	33	81.1	20
5. Reserves Deposited w/Lender	11	168	67	22	164	15	37	74.4	13.4	42	120.2	11.3	33	109.2	83.1
6. Title Charges	30	182	11	24	446	25	37	495.4	30	42	319.2	7	33	260	45
7. Government Recording and Transfer	30	54	4	24	177	18	37	61	14	42	34.2	8.1	33	243.0	11.2
8. Additional Settlement Costs	11	40	9	18	108	26	37	64	11	42	4.2	2.0	33	1	1
9. Total Settlement Costs Less Broker Fees	30	1093	113	24	2629	168	37	2487.3	194.0	42	2800.4	121.2	33	790	100.3
10. Line Item 9 Less Taxes	30	984	104	24	2348	166	37	2376.1	191.4	42	2676.0	122.1	30	481.1	48.4
11. Line Item 9 ÷ Line Item 1	30	2.3	.2	24	5.5	.4	37	5.3	.4	42	5.9	.3	33	1.7	.2
12. Line Item 10 ÷ Line Item 1	30	2.1	.2	24	4.9	.4	37	5.0	.4	42	5.7	3	30	1.6	.1

COST ITEMS	VIRGINIA			WASHINGTON			WEST VIRGINIA			WISCONSIN			WYOMING		
	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)	N	Mean ($ or %)	Std. Error ($ or %)
1. Contract Sales Price	29	47530.0	321	21	47380.2	318.2	19	47589.3	421	29	47104.1	242	41	47025.4	225.0
2. Broker's Commission Rate	22	5.7	.11	15	6.3	.2	9	5.3	.33	14	6.0	10	13	6.0	.23
3. Items Paid in Connection w/Loan	29	1322.0	210	21	897	63	19	381	193.3	29	857.0	70.4	41	1181.1	147
4. Items Required by Lender in Advance	29	289	37	21	205	56.4	19	22.1	14	29	180.4	35	41	195.3	26.3
5. Reserves Deposited w/Lender	29	204	26	21	91	31	19	11.1	8	29	158.1	45	41	84.1	14
6. Title Charges	29	468	20.0	21	413.4	26.3	19	321	25	29	284	30.2	41	210	7.0
7. Government Recording and Transfer	29	487	77.2	21	517	25.2	19	158	5.9	29	105.1	33	41	34	8
8. Additional Settlement Costs	29	84.0	13.2	21	.0	.0	19	41	34.4	29	6	4.0	41	35.2	8
9. Total Settlement Costs Less Broker Fees	29	2906.1	271	21	2297.0	123	19	934	249.4	29	1404	140	41	1743.1	119
10. Line Item 9 Less Taxes	29	2264.1	232	21	1704	115	19	766	246	28	1186.0	123	41	1652.4	148.4
11. Line Item 9 ÷ Line Item 1	29	6.1	.6	21	4.9	.3	19	2.0	.6	29	3.0	.3	41	3.7	.3
12. Line Item 10 ÷ Line Item 1	29	4.8	.5	21	3.6	.2	19	1.6	.5	28	2.5	.2	41	3.5	.3

We emphasize that the statistics are sample estimates and are therefore subject to sampling error. Cross-state comparisons must be made, therefore, with care and in light of the variability (standard error) of each estimate. Moreover, because these are sample estimates, we are precluded on methodological grounds from ranking the states from lowest to highest in settlement charges. We reiterate this very important point: It is methodologically inaccurate and improper to generate state rankings of lowest to highest settlement charges using these estimates.

SMSA Statistics

Exhibits XV-5 and XV-6 present average charges in the eight SMSAs for the following classes of settlement services.

- Contract sales price;
- Broker's commission percentage;
- Loan origination fee (HUD-1 Line Item 801);
- Loan discount fee (Line Item 802);
- Items payable in connection with loan (Series 800);
- Items required by lender to be paid in advance (Series 900);
- Reserves deposited with lender (Series 1000);
- Settlement or closing fee (Line Item 1101);
- Abstract or title search (Line Item 1102);
- Title exam (Line Item 1103);
- Document preparation (Line Item 1105);
- Attorneys' fees (Line Item 1107);
- Title insurance (Line Item 1108);
- Total title charges (Series 1100);
- Government recording and transfer charges (Series 1200);
- Additional settlement charges (Series 1300);
- Total settlement charges (Series 1400);
- Total settlement charges not including brokers' fees; and
- Total settlement charges not including brokers' fees and taxes.

EXHIBIT XV-5

SMSA Statistics - All Cases

	BOSTON							DENVER							D.C.							JACKSONVILLE						
	Buyer		Seller		Total			Buyer		Seller		Total			Buyer		Seller		Total			Buyer		Seller		Total		
	N	Ave	N	Ave	N	Ave	S.E.	N	Ave	N	Ave	N	Ave	S.E.	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					386	56186	1731					822	64421	1226					375	89896	2890					874	39388	550
2. Brokers' Commission Rate					124	5.9	.1					129	6.2	.1					135	4.8	.2					409	5.9	0.1
3. Items Payable in Connection	296	292	25	869	306	353	24	796	835	255	973	821	1112	28	347	608	120	557	353	787	34	698	356	802	1467	871	1635	24
w/Loan		420	8	574	166	427	25	777	551	34	496	805	553	11														
a. Loan Origination Fee	158	232	15	965	31	587	95	125	936	158	1193	282	1083	47	252	663	11	663	258	676	19	436	427	452	379	805	414	8
b. Loan Discount	16														10	862	90	631	97	674	57	16	460	732	1255	744	1244	20
c. Others (aggregate)	137	61	1	50	138	61	7	779	145	128	329	809	196	7	307	114	11	143	311	117	6	626	71	628	62	854	97	4
4. Items Required By Lender		200	3	423	108	206	16	743	303	26	326	744	314	8	268	380	3	212	268	382	15	846	213	38	367	857	227	6
Paid in Advance	105	426	2	155	312	426	15	395	78	29	763	420	126	14														
5. Reserves Deposited w/Lender	311	447	137	66	386	467	8	786	47	811	188	819	231	3	255	342	7	69	255	344	18	855	177	23	125	860	179	5
6. Title Charges	383														364	485	262	160	375	583	11	426	188	832	249	872	330	5
a. Settlement or Closing Fee	3	367	N/A	N/A	3	367	63	41	22	102	28	129	29	1	101	84	127	53	189	50	6	11	48	45	57	55	56	6
b. Abstract or Title Search	24	95	132	365	24	95	45	1	40	2	31	2	51	49	43	61	NA	NA	43	61	5	47	34	91	65	107	70	6
c. Title Examination	132	365	2	48	133	366	10	189	15	1	15	190	15	1	124	168	15	136	139	164	8	11	221	52	278	57	296	19
d. Document Preparation	99	65	74	46	145	68	6	55	83	21	14	75	65	6	122	50	100	36	182	54	3	13	50	27	45	39	48	3
e. Attorney Fees	242	407	52	100	250	415	9	31	23	3	93	33	30	7	143	302	91	225	210	303	11	108	165	264	143	348	160	7
f. Title Insurance	68	105	N/A	N/A	68	105	7	781	32	806	184	813	213	3	357	257	45	181	368	272	7	365	154	708	197	850	231	4
g. Others (aggregate)	317	23	14	24	317	23	5	168	14	24	31	186	17	2	145	25	45	23	172	27	6	25	33	413	14	434	15	1
7. Government Recording and Transfer	386	30	385	141	386	171	6	791	24	654	256	820	227	13	338	939	335	162	375	991	43	457	157	868	248	872	329	8
8. Additional Settlement Costs	212	61	6	56	215	61	1	421	40	9	133	427	42	2	211	83	96	57	221	105	5	237	85	518	122	592	141	5
9. Total Settlement Cost Not Including Broker Fees (TSC-BF)	386	1130	386	225	386	1355	34	822	1229	822	730	822	1958	34	375	2643	375	453	375	3096	65	874	905	874	1921	874	2827	33
10. TSC-BF Less Taxes (TSC-BF-T)	86	761	386	84	386	845	25	822	1181	822	526	822	1707	32	375	1582	375	307	375	1889	44	874	682	874	1672	874	2355	29
11. TSC-BF ÷ Contract Sales Price					386	3.0	0.1					822	3.4	0.1					375	3.9	0.1					874	7.5	0.1
12. TSC-BF-T ÷ Contract Sales Price					386	1.9	0.1					822	3.0	0.1					375	2.4	0.1					874	6.1	0.1

N = Number of Observations
Ave = Mean
S.E. = Standard Error of the Mean

EXHIBIT XV-8 (Continued)

	LOS ANGELES						
	Buyer		Seller		Total		
	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					454	74770	2173
2. Brokers' Commission Rates					86	5.2	0.2
3. Items Payable in Connection w/Loan	448	900	176	2280	453	1776	54
a. Loan Origination Fee	440	804	14	1108	448	825	22
b. Loan Discount	21	388	163	2269	183	2066	74
c. Others (aggregate)	435	78	132	76	452	98	8
4. Items Required By Lender Paid in Advance	442	442	9	324	445	426	13
5. Reserves Deposited w/Lender	288	216	3	291	291	217	16
6. Title Charges	446	257	432	390	453	619	13
a. Settlement or Closing Fee	340	144	359	156	434	242	6
b. Abstract or Title Search	5	30	18	52	22	49	13
c. Title Examination	NA	NA	4	21	4	21	10
d. Document Preparation	88	42	275	37	297	47	3
e. Attorney Fees	5	165	4	129	8	168	68
f. Title Insurance	436	115	381	246	445	323	7
g. Others (aggregate)	212	39	246	29	351	43	4
7. Government Recording and Transfer	444	26	449	121	453	146	10
8. Additional Settlement Costs	57	149	209	216	238	225	27
9. Total Settlement Costs Not Including Broker Fees (TSC-BF)	454	1798	454	1482	454	3281	65
10. TSC-BF less Taxes (TSC-BF-T)	454	1670	454	1361	454	3031	60
11. TSC-BF ÷ Contract Sales Price					454	4.9	0.1
12. TSC-BF-T ÷ Contract Sales Price					454	4.6	0.1

	ST. LOUIS						
	Buyer		Seller		Total		
	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					758	60919	1407
2. Brokers' Commission Rates					229	5.7	0.1
3. Items Payable in Connection w/Loan	744	483	57	421	747	573	12
a. Loan Origination Fee	690	622	5	482	695	423	10
b. Loan Discount	10	146	18	1098	28	758	120
c. Others (aggregate)	669	95	39	44	673	97	2
4. Items Required By Lender Paid in Advance	493	267	7	241	495	269	9
5. Reserves Deposited w/Lender	576	125	2	110	578	125	4
6. Title Charges	743	357	330	36	752	368	5
a. Settlement or Closing Fee	261	36	126	44	299	49	5
b. Abstract or Title Search	11	88	18	38	26	64	21
c. Title Examination	28	244	2	53	29	239	38
d. Document Preparation	8	23	12	15	19	19	4
e. Attorney Fees	9	62	19	71	24	80	34
f. Title Insurance	709	342	20	149	718	342	5
g. Others (aggregate)	87	56	212	6	251	24	5
7. Government Recording and Transfer	747	17	561	7	754	22	1
8. Additional Settlement Costs	394	81	40	146	414	90	4
9. Total Settlement Costs Not Including Broker Fees (TSC-BF)	758	1162	758	63	758	1225	20
10. TSC-BF less Taxes (TSC-BF-T)	758	1068	758	57	758	1126	19
11. TSC-BF ÷ Contract Sales Price					758	2.4	0.1
12. TSC-BF-T ÷ Contract Sales Price					758	2.2	0.1

	SAN ANTONIO						
	Buyer		Seller		Total		
	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					330	55948	1939
2. Brokers' Commission Rates					106	5.0	0.1
3. Items Payable in Connection w/Loan	300	388	138	712	312	687	32
a. Loan Origination Fee	236	387	50	344	258	420	14
b. Loan Discount	12	379	96	774	105	751	49
c. Others (aggregate)	177	101	63	77	202	113	8
4. Items Required By Lender Paid in Advance	301	404	30	399	304	439	19
5. Reserves Deposited w/Lender	306	173	16	83	312	174	12
6. Title Charges	298	115	330	398	330	502	9
a. Settlement or Closing Fee	126	25	141	26	146	47	1
b. Abstract or Title Search	1	9	4	109	5	89	51
c. Title Examination	3	16	4	76	4	89	17
d. Document Preparation	141	59	84	42	213	55	2
e. Attorney Fees	126	65	181	49	261	66	3
f. Title Insurance	287	38	320	345	329	368	8
g. Others (aggregate)	193	19	169	24	261	29	2
7. Government Recording and Transfer	320	77	306	34	330	105	7
8. Additional Settlement Costs	244	72	106	64	269	91	4
9. Total Settlement Costs Not Including Broker Fees (TSC-BF)	330	1187	330	[illegible]	330	1975	57
10. TSC-BF less Taxes (TSC-BF-T)	330	999	330	753	330	1753	48
11. TSC-BF ÷ Contract Sales Price					330	4.1	0.1
12. TSC-BF-T ÷ Contract Sales Price					330	3.7	0.1

	SEATTLE						
	Buyer		Seller		Total		
	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					812	58949	979
2. Brokers' Commission Rates					547	6.1	0.1
3. Items Payable in Connection w/Loan	808	1057	78	1345	811	1176	20
a. Loan Origination Fee	789	967	5	858	793	968	16
b. Loan Discount	57	418	60	1654	110	1096	77
c. Others (aggregate)	406	155	20	69	408	158	6
4. Items Required By Lender Paid in Advance	578	244	4	1768	580	255	11
5. Reserves Deposited w/Lender	320	167	2	652	322	176	8
6. Title Charges	807	118	801	264	811	369	6
a. Settlement or Closing Fee	239	130	260	131	262	249	6
b. Abstract or Title Search	NA	NA	NA	NA	NA	NA	NA
c. Title Examination	2	106	1	196	3	136	36
d. Document Preparation	3	26	11	54	13	52	27
e. Attorney Fees	31	126	81	81	84	125	20
f. Title Insurance	797	76	793	204	806	275	4
g. Others (aggregate)	2	29	2	91	3	80	66
7. Government Recording and Transfer	419	28	810	641	812	654	11
8. Additional Settlement Costs	23	107	39	169	55	164	48
9. Total Settlement Costs Not Including Broker Fees (TSC-BF)	812	1584	812	1038	812	2622	36
10. TSC-BF less Taxes (TSC-BF-T)	812	1515	812	398	312	1913	28
11. TSC-BF ÷ Contract Sales Price					812	4.7	0.1
12. TSC-BF-T ÷ Contract Sales Price					812	3.5	0.1

N = Number of Observations
Ave = Mean
S.E. = Standard Error of Mean

EXHIBIT XV-6

$55,000-$60,000 Range
SMSA STATISTICS - ALL CASES

	BOSTON							DENVER						
	Buyer		Seller		Total			Buyer		Seller		Total		
Costs	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					25	57062	334					81	57818	174
2. Brokers' Commission Rates					8	5.8	0.2							
3. Items Payable in Connection w/Loan	15	291	1	1440	16	362	110	70	764	31	1203	81	1120	80
a. Loan Origination Fee	8	428	NA	NA	8	428	98	66	499	15	485	78	516	15
b. Loan Discount	1	390	1	1440	2	915	525	11	965	24	1031	34	1040	103
c. Others (aggregate)	10	33	NA	NA	10	33	10	66	148	20	255	80	186	22
4. Items Required By Lender Paid in Advance	7	372	NA	NA	7	372	89	73	270	8	231	74	291	22
5. Reserves Deposited w/Lender	21	368	NA	NA	21	368	50	39	79	1	618	40	92	26
6. Title Charges	24	459	11	47	25	461	24	66	44	81	183	81	219	7
a. Settlement or Closing Fee	2	358	NA	NA	2	358	108	4	20	8	44	11	39	12
b. Abstract or Title Search	2	33	NA	NA	2	33	18	NA	NA	NA	NA	NA	NA	NA
c. Title Examination	7	322	NA	NA	7	322	56	12	15	1	15	13	15	0
d. Document Preparation	7	106	8	39	11	95	38	5	95	1	15	6	82	13
e. Attorney Fees	16	412	3	52	16	421	28	7	13	NA	NA	7	13	2
f. Title Insurance	4	88	NA	NA	4	88	9	66	30	81	178	81	202	5
g. Others (aggregate)	18	17	1	50	18	19	3	12	10	5	10	17	10	1
7. Government Recording and Transfer	23	25	25	142	25	165	3	66	21	69	220	81	205	39
8. Additional Settlement Costs	18	56	NA	NA	18	56	3	41	41	1	500	42	52	11
9. Total Settlement Costs Not Including Broker Fees (TSC-BF)	25	1091	25	220	25	1311	132	81	1030	81	867	81	1897	85
10. TSC-BF less Taxes (TSC-BF-T)	25	762	25	78	25	840	102	81	990	81	680	81	1670	81
11. TSC-BF ÷ Contract Sales Price					25	2.3	0.2					81	3.3	0.1
12. TSC-BF-T ÷ Contract Sales Price					25	1.5	0.2					81	2.9	0.1

	D.C.							JACKSONVILLE						
	Buyer		Seller		Total			Buyer		Seller		Total		
Costs	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.	N	Ave ($)	N	Ave ($)	N	Ave ($)	S.E.
1. Contract Sales Price					27	57348	308					36	57269	262
2. Brokers' Commission Rates					8	4.9	0.4					8	4.3	0.2
3. Items Payable in Connection w/Loan	26	506	10	307	27	647	66	28	503	28	2198	36	2074	103
a. Loan Origination Fee	20	495	2	298	21	500	13	18	569	19	684	36	643	43
b. Loan Discount	NA	NA	8	437	8	437	48	7	228	22	2012	24	1863	134
c. Others (aggregate)	23	141	3	21	23	144	36	22	101	24	124	34	153	29
4. Items Required By Lender Paid in Advance	23	419	NA	NA	23	419	80	34	305	NA	NA	34	303	32
5. Reserves Deposited w/Lender	24	392	2	96	24	400	100	36	239	1	98	36	242	26
6. Title Charges	27	379	15	194	27	487	21	19	172	34	305	36	378	11
a. Settlement or Closing Fee	2	60	4	18	6	32	10	NA	NA	NA	NA	NA	NA	NA
b. Abstract or Title Search	4	34	NA	NA	4	34	9	NA	NA	NA	NA	NA	NA	NA
c. Title Examination	6	193	NA	NA	6	193	11	NA	NA	1	325	1	325	0
d. Document Preparation	7	43	6	39	11	49	8	3	50	1	50	4	50	0
e. Attorney Fees	10	353	6	195	15	314	29	6	134	18	111	24	117	11
f. Title Insurance	27	179	7	197	27	230	18	14	165	32	245	35	290	16
g. Others (aggregate)	10	17	5	10	13	17	5	NA	NA	10	13	10	13	3
7. Government Recording and Transfer	21	709	24	261	27	783	68	16	266	36	430	36	548	36
8. Additional Settlement Costs	7	78	5	66	7	125	32	2	83	10	112	11	117	30
9. Total Settlement Costs Not Including Broker Fees (TSC-BF)	27	2289	27	518	27	2807	145	36	1162	36	2462	36	3621	168
10. TSC-BF less Taxes (TSC-BF-T)	27	1401	27	279	27	1680	87	36	841	36	2029	36	2869	166
11. TSC-BF ÷ Contract Sales Price					27	4.9	0.3					36	6.3	0.3
12. TSC-BF-T ÷ Contract Sales Price					27	2.9	0.2					36	5.0	0.3

N = Number of Observations
Ave = Mean
S.E. = Standard Error of Mean

EXHIBIT XV-6 (Continued)

	LOS ANGELES							ST. LOUIS						
	Buyer		Seller		Total			Buyer		Seller		Total		
	N	Ave	N	Ave($)	N	Ave	S.E.	N	Ave($)	N	Ave	N	Ave($)	S.E.
1. Contract Sales Price					38	57338	235					55	57487	207
2. Brokers' Commission Rate					8	5.2	0.6					13	5.8	0.1
3. Items Payable in Connection w/Loan	37	727	20	2310	38	1923	192	53	488	3	731	53	530	45
a. Loan Origination Fee	36	669	1	573	37	666	31	51	407	NA	NA	51	407	13
b. Loan Discount	1	268	19	2263	20	2163	179	1	60	1	2080	2	1070	1010
c. Others (aggregate)	35	72	16	99	38	108	23	50	99	3	36	50	101	9
4. Items Required By Lender Paid in Advance	38	382	1	108	38	385	27	38	264	NA	NA	38	264	25
5. Reserves Deposited w/Lender	32	213	NA	NA	32	213	33	47	121	NA	NA	47	121	11
6. Title Charges	37	211	37	402	38	596	41	55	357	12	20	55	362	9
a. Settlement or Closing Fee	29	134	28	169	37	232	14	18	38	5	31	20	42	6
b. Abstract or Title Search	NA	NA	4	83	4	83	65	NA	NA	1	50	1	50	[illegible]
c. Title Examination	NA	NA	1	50	1	50	0	1	367	NA	NA	1	367	0
d. Document Preparation	6	25	24	45	26	47	9	NA	NA	NA	NA	NA	NA	NA
e. Attorney Fees	NA	NA	1	170	1	170	0	1	352	NA	NA	1	352	0
f. Title Insurance	34	94	34	202	37	272	11	53	344	1	20	53	345	9
g. Others (aggregate)	16	36	25	65	34	65	26	1	2	9	2	10	2	1
7. Government Recordings and Transfer	37	30	37	103	38	129	23	55	15	39	4	55	18	1
8. Additional Settlement Costs	3	70	17	221	18	221	97	35	75	4	115	36	85	14
9. Total Settlement Cost Not Including Broker Fees (TSC-BF)	38	1550	38	1809	38	3359	232	55	1183	55	55	55	1239	59
10. TSC-BF Less Taxes (TSC-BF-T)	38	1393	38	1709	38	3102	222	55	1082	55	53	55	1134	57
11. TSC-BF ÷ Contract Sales Price					38	5.9	0.4					55	2.2	0.1
12. TSC-BF-T ÷ Contract Sales Price					38	5.4	0.4					55	2.0	0.1

	SAN ANTONIO							SEATTLE						
	Buyer		Seller		Total			Buyer		Seller		Total		
	N	Ave($)	N	Ave($)	N	Ave($)	S.E.	N	Ave	N	Ave($)	N	Ave	S.E.
1. Contract Sales Price					21	57433	333					84	57344	179
2. Brokers' Commission Rate					8	4.9	0.5					52	6.3	0.1
3. Items Payable in Connection w/Loan	21	556	11	800	21	975	126	84	1124	12	1802	84	1382	70
a. Loan Origination Fee	20	466	5	171	20	509	10	84	1005	NA	NA	84	1005	38
b. Loan Discount	1	300	8	965	8	1002	147	6	330	10	2156	16	1471	272
c. Others (aggregate)	12	147	2	56	13	144	41	46	172	2	33	46	173	23
4. Items Required By Lender Paid in Advance	19	456	5	325	20	514	57	59	308	NA	NA	59	308	31
5. Reserves Deposited w/Lender	20	161	1	99	21	158	22	35	175	NA	NA	35	175	19
6. Title Charges	18	102	21	408	21	495	14	83	124	83	271	83	395	21
a. Settlement or Closing Fee	2	30	5	27	5	39	9	26	135	29	170	29	291	30
b. Abstract or Title Search	[illegible]	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
c. Title Examination	3	16	3	88	3	105	9	NA	NA	NA	NA	NA	NA	NA
d. Document Preparation	9	63	5	57	13	61	6	NA	NA	1	35	1	35	0
e. Attorney Fees	7	81	9	48	14	71	21	3	136	7	76	7	134	49
f. Title Insurance	15	34	21	346	21	370	6	82	78	82	207	83	282	9
g. Others (aggregate)	20	15	13	13	20	16	4	NA	NA	NA	NA	NA	NA	NA
7. Government Recordings and Transfer	18	90	21	26	21	104	14	47	26	84	627	84	642	12
8. Additional Settlement Costs	12	68	4	40	12	81	11	3	117	7	352	9	313	244
9. Total Settlement Cost Not Including Broker Fees (TSC-BF)	21	1471	21	942	21	2413	152	84	1712	84	1182	84	2893	94
10. TSC-BF Less Taxes (TSC-BF-T)	21	1272	21	914	21	2186	157	84	1640	84	554	84	2194	90
11. TSC-BF ÷ Contract Sales Price					21	4.2	0.3					84	5.1	0.2
12. TSC-BF-T ÷ Contract Sales Price					21	3.8	0.3					84	3.8	0.2

N = Number of Observations
Ave = Mean
S.E. = Standard Error of the Mean

Many of these charges are the same as those listed in the national and state exhibits. They differ in two respects:

- Buyer and seller charges as well as totals for each cost category are presented in the current exhibits; and
- Estimates of certain detailed settlement charges, not presented in the previous exhibits, are explicitly shown here because of particular interest in these topics at the local level (e.g., loan origination fee, attorneys' fees, etc.).

Exhibit XV-5 presents statistics based on the full set of HUD-1s received from lenders in each SMSA. The key findings from Exhibit XV-5 are:

- The distribution of individual and total settlement costs between buyer and seller varies widely across SMSAs reflecting a great diversity of local practice.
- In all SMSAs except Boston, items paid in connection with the loan represented the largest proportion of total settlement costs accounting for between 20 and 60 percent of total costs.
- In most SMSAs, title charges constituted the second largest portion of total settlement costs, followed by items required by the lender to be paid in advance or government recording and transfer charges.
- Total settlement charges, not including broker fees, ranged from a low of 2.4 percent of contract sales price in St. Louis to 7.5 percent in Jacksonville.
- Total settlement charges not including broker fees and taxes ranged from 1.9 percent of sales price in Boston to 6.3 percent in Jacksonville.

To facilitate cross market comparisons, Exhibit XV-6 presents the statistics of the previous exhibit for HUD-1s with a contract sales price of $55,000 to $60,000.[1] A review of this exhibit yields the following findings:

- Except in Boston, items paid in connection with the loan consitute the most expensive settlement cost class accounting for between 23 and 57 percent of total settlement charges.

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[1] The range $55,000 to $60,000 constitutes the mode of the distribution of SMSA contract sales price.

- Items required by the lender to be paid in advance, government recording and transfer charges or title charges make up the second largest proportion of total settlement costs.

- Total settlement charges not including broker fees as a percentage of contract sales price ranged from 2.2 percent in St. Louis to 6.3 percent in Jacksonville.

- Total settlement charges not including broker fees and taxes as a percentage of contract sales price, ranged from 1.5 percent in Boston to 5.4 percent in Los Angeles.

COMPARATIVE ANALYSIS OF 1979 AND 1975 SETTLEMENT CHARGES

This section compares settlement charges from the 1979 HUD-1 survey with the same charges from the 1975 survey of settlement costs conducted by HUD. It is not an exhaustive comparative analysis of the two data sets. Rather, its purpose is to shed some light on the question of whether settlement charges have increased, decreased, or remained the same since the passage of RESPA. This analysis, therefore, by implication, addresses the issue of whether settlement service markets have become more price competitive since RESPA.

In September of 1975, HUD collected data on actual settlement charges in seven selected housing markets:

- Suffolk County, Massachusetts (Boston);

- District of Columbia;

- Fairfield County, Connecticut (Bridgeport);

- Los Angeles County, California (Los Angeles);

- Orange County, Florida (Orlando);

- Polk County, Iowa (Des Moines); and

- Denver County, Colorado (Denver).

Four of these areas coincide with the eight markets surveyed in the 1979 HUD-1 data collection. They are Boston, Denver, District of Columbia, and Los Angeles.

This analysis compares actual settlement charges in these areas in 1975 with those in 1979. It focuses on the comparison of three quantities:

- average contract sales price;

- total title assurance charges; and

- total settlement charges not including broker fees and taxes.

Our focus is primarily on title assurance charges rather than total settlement charges because changes in total settlement charges may be caused by changes in the mix of settlement services offered and in the methods of payment for those services. For example, if high loan-to-value ratio mortgage loans became more common over the period studied, the use of mortgage insurance would have increased, boosting total settlement costs. Other possible changes making the interpretation of 1979-1975 differences more ambiguous are changes in the number of points required by lenders (points are a substitute for changes in interest rates) and changes in the payment plans used for mortgage insurance. Title assurance charges are much less likely to substantially reflect these kinds of changes. As a result, observed price differences in title charges over time are likely to reflect changes in prices for a relatively unchanged product.

Exhibit XV-7 displays estimates of the three quantities computed from the 1979 and 1975 data sets. Combined averages for contract sales price, total title assurance charges, and average total settlement charges are derived by averaging the individual city statistics.

If there were no fundamental change in settlement charges, these costs would be expected to increase over the period, but the increase would be somewhat lower than the increase in the price of housing and somewhat higher than the increase in the CPI. This expectation follows from the fact that individual settlement charges may be categorized into one of two fundamental types:

- charges related to the sales price of the house; or

- charges that are relatively fixed or independent of the sales price.

Charges of the first type will follow generally the rise in housing prices, whereas charges of the second type will rise with the general level of inflation in the economy. We estimated the increase in total title charges between 1975 and 1979 that could have been expected due to inflation if there were no fundamental changes in the structure of title charges. This is shown in the table below.

EXHIBIT XV-7

SETTLEMENT CHARGES, 1975 & 1979

1979 Settlement Charges ($)

	Sales Price			Total Title Charges 1/			Total Settlement Charges 2/		
	N	Ave ($)	Std. Error ($)	N	Ave ($)	Std. Error ($)	N	Ave ($)	Std. Error ($)
Boston	386	56186	1731	386	467	8	386	845	25
Denver	822	64421	1226	819	231	3	822	1707	32
D.C.	375	89896	2590	375	583	11	375	1889	44
Los Angeles	454	74770	2173	453	619	13	454	3031	60
TOTALS	2036	71318	997	2034	475	5	2036	1868	21

1975 Settlement Charges ($)

	Sales Price			Total Title Charges 1/			Total Settlement Charges 2/		
	N	Ave ($)	Std. Error ($)	N	Ave ($)	Std. Error ($)	N	Ave ($)	Std. Error ($)
Boston	57	48399	2564	57	424	17	57	884	62
Denver	335	39468	1070	235	235	10	235	1518	47
D.C.	107	57292	3251	107	487	19	107	1823	108
Los Angeles	300	52139	1909	300	560	13	300	1938	54
TOTALS	699	49325	1170	699	427	8	699	1540	36

1/ Total Title Assurance Charges refers to all charges to both buyers and sellers appearing under Series 1100 under the HUD-1 Form.

2/ Total Settlement Charges refers to all settlement charges to both buyers and sellers less broker commissions and state and local taxes.

SOURCE: 1975 and 1979 HUD-1 Surveys

	1975	1979	Change 1975-1979
Average House Sales Price	$49,325	$71,318	44.6
Title Insurance Premium (estimated)	175	241	37.7
Projected Total Title Charges (an increase in related expenses of 24%)	427	553	29.5

The estimated title insurance premium is that indicated by the most commonly used owner's title insurance premium schedule: $3.50 per $1,000 for the first $50,000 of coverage and $3.00 per $1,000 for coverage between $50,000 and $100,000. Other title related charges, both for the search and examination and conveyancing services, are assumed to be total actual charges less estimated title premium charges. In projecting total title charges in 1979, it is assumed that title insurance premiums increase as per this premium schedule (average $175 in 1975, $241 in 1979) given the increase in sales prices, and estimated other title related charges increase by the same percentage as the increase in the overall cost of living, or 24.0 percent. Total title insurance charges, had there been no structural change in title charges due to RESPA, changes in competitive conditions or other factors, would be projected to increase from $427 to $553 or by 30 percent. This is less than the increase in the average house sales price of 44.6 percent but greater than the increase in the cost of living of 24.0 percent.

This estimating procedure is admittedly rough and is designed only to provide some guidance as to how to determine whether title charges have decreased or increased more than expected if fundamental changes did not occur in market conditions. If the observed increases were less than the increase in the CPI, we might surmise that settlement charges have declined in real terms. If the increase approximated or was slightly greater than the increase in the CPI, we might surmise that settlement charges have not significantly changed since 1975. Finally, if the increase in charges was substantially greater than the increase in the CPI, either approximating or exceeding the increase in housing prices, we would surmise that settlement charges increased over the period.

Exhibit XV-8 gives the percentage charges in (1) average sales price; (2) total title charges; (3) total settlement charges; and (4) the Consumer Price Index (CPI) for the period September 1975 through December 1978, (the average closing date for the HUD-1s Survey in 1979).

A review of the change in average title assurance charges from 1975 to 1979 indicates that these charges increased, but by a significantly lower percentage than either housing prices or the CPI. Average title assurance charges increased 11 percent from $427 in September 1975 to $475 in December 1978.

EXHIBIT XV-8

PERCENTAGE INCREASES FROM 1975 TO 1979[1]

	Sales Price	Total Title Charges	Total Settlement Charges	CPI[2]
% Increase 9/75 to 1/79	44.6%	11.2%	21.2%	24.0%

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[1] The average date of closing for the 1978-1979 Survey of HUD-IS was estimated at Jan. 1, 1980.

[2] The CPI for September, 1975 and December 1978 was 163.8 and 203.9 respectively.

This compares to a 45 percent increase in housing prices and a 24 percent increase in consumer prices occurring over the same period. We conclude that title assurance charges (including other associated legal and conveyancing charges) declined in real terms on the average priced house during the 3-1/2 year period.

Total settlement charges to both the buyer and seller (not including brokerage commissions and state and local taxes) increased 21 percent, from $1,540 in September 1975 to $1,868 at the end of 1978. The increase was slightly less than the 24 percent increase in overall inflation and substantially less than the 45 percent increase in housing prices. Stated in somewhat different terms, average total settlement charges less brokerage fees and taxes fell in real terms between 1975 and 1979.

A similar analysis of average total title costs and average total settlement charges using discrete, narrow ranges of contract sales prices as opposed to averages for the entire set of data from these four SMSAs yields similar results. That is, average title assurance charges and average total settlement charges decreased in real terms between September 1975 and December 1979.

What we have seen is a decline in charges for the package of title insurance and related services. The observed decline in total settlement charges may not be real but, as indicated earlier, may reflect changes in the mix of services provided or changes in methods of paying for those services. The decline in the real price of title insurance and related services could have resulted from a move toward greater price competitiveness in the market for these services in the four cities studied, or perhaps from some other factors.

Our survey of providers plus information derived from other sources indicates that the title insurance premium schedule used in most localities has not changed in recent years. This schedule, described above, calls for premiums to increase only slightly less than proportionately with the sales price. The relatively small (11 percent) increase in the sum of title insurance premiums and related charges in the four sites between 1975 and 1978 may primarily reflect increased competition among lawyers and other providers who arrange for title insurance and who supply related services. This increased competition could have caused some decline in the charges for those other services, which might be subsidized by the high title insurance commissions prevailing in many areas.

RESPA may have had a role in this change through the provision of greater and more timely information about settlement and its emphasis on comparitive shopping for settlement services; but so could the Bates decision precluding bans on attorney advertising, or newspaper articles in Washington, D.C. and elsewhere on settlement provider practices.

These data, per se, do not indicate that active price competition prevails in each of these markets. Analyses of market performance for both private mortgage insurance and title assurance and conveyancing services suggests that active price competition is not present in many areas and prices are higher than necessary.

We must, of course, qualify our conclusions with the following caveats. First, both approaches for measuring changes in settlement costs assume that increases in housing prices reflect housing inflation only and not structural changes in the size and characteristics of the housing demanded by home buyers. That is, we assume the kind of housing home buyers demand did not change during the period. As more than two-thirds of all single family residential housing was of the existing variety during this period, this assumption appears valid. Second, because the data used in the analysis are taken from four selected housing markets and because the representativeness of these markets of the national market for settlement services is equivocal, the conclusions reached here pertain to the housing markets studied and may not be generalizable to the market for settlement services in other large urban areas and not to the nation as a whole.

CONCLUSIONS

Our model for assessing RESPA's effectiveness and for cataloguing the various effects or impacts of the legislation contains three discrete but interrelated components:

- compliance with and implementation of RESPA's provisions;
- changes in the settlement system, process, and procedures due to RESPA; and
- the impact of these changes in the settlement system on the prices providers charge consumers for their services.

Our examination of RESPA compliance and implementation indicates that the letter and intent of the RESPA provisions we studied are, for the most part, being complied with, in that:

- Nearly all lenders claim they distribute the SIB and GFEs within the required time frame;
- Most consumers receive the SIB (57 percent) and GFEs (83 percent);
- Most consumers find the SIB adequate and the GFEs to be reasonably accurate estimates of actual settlement charges;
- The one day prior inspection of the HUD-1 is in place, although few home buyers (20 percent) exercise this right.

However, a significant proportion of both providers and consumers have complaints about the HUD-1. They claim it is too complex, it is difficult to understand, and it possesses definitional and interpretive problems.

Our analysis of changes in the settlement system, process and procedures focused on (1) the extent of readership of the SIB, (2) the extent of consumer shopping for settlement services and (3) RESPA's influence on the shopping behavior of consumers. Key findings include:

- Between 8 and 9 of every 10 home buyers who receive the SIB read all or some parts of it;
- Between 3 and 5 of every 10 home buyers engage in some degree of comparative shopping; and
- The RESPA provisions induce at least 1 of every 10 home buyers to engage in some degree of comparative shopping.

Theoretically, RESPA would exert downward pressure on the prices providers charge through the development of more price competitive settlement service markets. Isolating RESPA's marginal effect is, however, an impossible task. Therefore, in the third component of the model we focused on estimating current settlement service prices and determining whether and to what extent settlement service prices have changed since RESPA's inception, irrespective of the source of the change.

Our conclusions include:

- For the 50 states and 8 SMSAs for which data were collected, total settlement charges not including broker fees averaged $2,030 or 3.7 percent of the average contract sales price of $54,864. This percentage ranged from a low of 1.6 percent in Iowa to 6.8 percent in Oklahoma.
- Total settlement charges, less broker fees and taxes, averaged $1,657 or 3.0 percent of average contract sales price, with a low of 1.2 percent in Vermont and a high of 6.3 percent in Oklahoma and Mississippi.
- Items payable in connection with the loan constituted the most expensive settlement cost class at $975 or 48 percent of total settlement charges, followed by title charges at $389 (19 percent); items required by the lender to be paid in advance at $318 (16 percent); government recording and transfer fees at $253 (12 percent); reserves at $211 (10 percent); and additional settlement charges at $104 (5 percent).

- The distribution of individual and total settlement charges between buyer and seller varies widely across geographic areas, reflecting great diversity of local and regional practice.

- In the four coincident sites from the 1975 and 1979 HUD-1 surveys, average total title assurance charges increased 11 percent from $427 in 1975 to $475 in December 1978. This compares to a 45 percent increase in the average contract sales price of homes in these sites and a 24 percent increase in the Consumer Price Index over this same period. These data indicate that average total title assurance costs declined in real terms over this three and one-half year period.

APPENDIX A

REAL ESTATE SETTLEMENT PROCEDURES ACT

THE REAL ESTATE SETTLEMENT PROCEDURES ACT OF 1974 AS AMENDED IN 1975

An Act

88 STAT. 1724

To further the national housing goal of encouraging homeownership by regulating certain lending practices and closing and settlement procedures in federally related mortgage transactions to the end that unnecessary costs and difficulties of purchasing housing are minimized, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Real Estate Settlement Procedures Act of 1974.

SHORT TITLE

SECTION 1. This Act may be cited as the "Real Estate Settlement Procedures Act of 1974". 12 USC 2601 note.

FINDINGS AND PURPOSE

SEC. 2. (a) The Congress finds that significant reforms in the real estate settlement process are needed to insure that consumers throughout the Nation are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges caused by certain abusive practices that have developed in some areas of the country. The Congress also finds that it has been over two years since the Secretary of Housing and Urban Development and the Administrator of Veterans' Affairs submitted their joint report to the Congress on "Mortgage Settlement Costs" and that the time has come for the recommendations for Federal legislative action made in that report to be implemented. 12 USC 2601.

(b) It is the purpose of this Act to effect certain changes in the settlement process for residential real estate that will result—

(1) in more effective advance disclosure to home buyers and sellers of settlement costs;

(2) in the elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services;

(3) in a reduction in the amounts home buyers are required to place in escrow accounts established to insure the payment of real estate taxes and insurance; and

(4) in significant reform and modernization of local recordkeeping of land title information.

DEFINITIONS

SEC. 3. For purposes of this Act— 12 USC 2602.

(1) the term "federally related mortgage loan" includes any loan (other than temporary financing such as a construction loan) which—

a first lien on

(A) is secured by residential real property (including individual units of condominiums and cooperatives) designed principally for the occupancy of from one to four families; and

(B)(i) is made in whole or in part by any lender the deposits or accounts of which are insured by any agency of the Federal Government, or is made in whole or in part by any lender which is regulated by any agency of the Federal Government; or

(ii) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by the Secretary or any other officer or agency of the Federal Government or under or in connection with a housing or urban development program administered by the Secretary or a housing or related program administered by any other such officer or agency; or

(iii) is intended to be sold by the originating lender to the Federal National Mortgage Association, the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a financial institution from which it is to be purchased by the Federal Home Loan Mortgage Corporation; or

(iv) is made in whole or in part by any "creditor", as defined in section 103(f) of the Consumer Credit Protection Act (15 U.S.C. 1602(f)), who makes or invests in residential real estate loans aggregating more than $1,000,000 per year; except that for the purpose of this Act, the term 'creditor' does not include any agency or instrumentality of any State.

(2) the term "thing of value" includes any payment, advance, funds, loan, service, or other consideration;

(3) the term "settlement services" includes any service provided in connection with a real estate settlement including, but not limited to, the following: title searches, title examinations, the provision of title certificates, title insurance, services rendered by an attorney, the preparation of documents, property surveys, the rendering of credit reports or appraisals, pest and fungus inspections, services rendered by a real estate agent or broker, and the handling of the processing, and closing or settlement;

(4) the term "title company" means any institution which is qualified to issue title insurance, directly or through its agents, and also refers to any duly authorized agent of a title company;

(5) the term "person" includes individuals, corporations, associations, partnerships, and trusts; and

(6) the term "Secretary" means the Secretary of Housing and Urban Development.

(a) UNIFORM SETTLEMENT STATEMENT

12 USC 2603. Sec. 4. The Secretary, in consultation with the Administrator of Veterans' Affairs, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board, shall develop and prescribe a standard form for the statement of settlement costs which shall be used (with such variations as may be necessary to reflect differences in legal and administrative requirements or practices in different areas of the country) as the standard real estate settlement form in all transactions in the United States which involve federally related mortgage loans. Such form shall conspicuously and clearly itemize all charges imposed upon the borrower and all charges imposed upon the seller in connection with the settlement and shall indicate whether any title insurance premium included in such charges covers or insures the lender's interest in the property, the borrower's interest, or both. The Secretary may, by regulation, permit the deletion from the form prescribed under this section of items which are not, under local laws or customs, applicable in any locality, except that such regulation shall require that the numerical code prescribed by the Secretary be retained in forms to be used in all localities. Nothing in this section may be construed to require that that part of the standard form which relates to the borrower's transaction be furnished to the seller, or to require that that part of the standard form which relates to the seller be furnished to the borrower.

(b) The form prescribed under this section shall be completed and made available for inspection by the borrower at or before settlement by the person conducting the settlement, except that (1) the Secretary may exempt from the requirements of this section settlements occurring in localities where the final settlement statement is not customarily provided at or before the date of settlement, or settlements where such requirements are impractical and (2) the borrower may, in accordance with regulations of the Secretary, waive his right to have the form made available at such time. Upon the request of the borrower to inspect the form prescribed under this section during the business day immediately preceding the day of settlement, the person who will conduct the settlement shall permit the borrower to inspect those items which are known to such person during such preceding day.

SPECIAL INFORMATION BOOKLETS

12 USC 2604. Sec. 5. (a) The Secretary shall prepare and distribute booklets to help persons borrowing money to finance the purchase of residential real estate better to understand the nature and costs of real estate settlement services. The Secretary shall distribute such booklets to all lenders which make federally related mortgage loans.

(b) Each booklet shall be in such form and detail as the Secretary shall prescribe and, in addition to such other information as the Secretary may provide, shall include in clear and concise language—

(1) a description and explanation of the nature and purpose of each cost incident to a real estate settlement;

(2) an explanation and sample of the standard real estate settlement form developed and prescribed under section 4;

(3) a description and explanation of the nature and purpose of escrow accounts when used in connection with loans secured by residential real estate;

(4) an explanation of the choices available to buyers of residential real estate in selecting persons to provide necessary services incident to a real estate settlement; and

(5) an explanation of the unfair practices and unreasonable or unnecessary charges to be avoided by the prospective buyer with respect to a real estate settlement.

Such booklets shall take into consideration differences in real estate settlement procedures which may exist among the several States and territories of the United States and among separate political subdivisions within the same State and territory.

(c) Each lender shall include with the booklet a good faith estimate of the amount or range of charges for specific settlement services the borrower is likely to incur in connection with the settlement as prescribed by the Secretary.

(d) Each lender referred to in subsection (a) shall provide the booklet described in such subsection to each person from whom it receives or for whom it prepares a written application to borrow money to finance the purchase of residential real estate. Such booklet shall be provided at the time of receipt or preparation of such application.

(e) Booklets may be printed and distributed by lenders if their form and content are approved by the Secretary as meeting the requirements of subsection (b) of this section.

PROHIBITION AGAINST KICKBACKS AND UNEARNED FEES

12 USC 2607. Sec. 8. (a) No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.

(b) No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed.

(c) Nothing in this section shall be construed as prohibiting (1) the payment of a fee (A) to attorneys at law for services actually rendered or (B) by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance or (C) by a lender to its duly appointed agent for services actually performed in the making of a loan, (2) the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed, or (3) payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers, or (4) such other payments or classes of payments or other transfers as are specified in regulations prescribed by the Secretary, after consultation with the Attorney General, the Administrator of Veterans' Affairs, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Secretary of Agriculture .

(d)(1) Any person or persons who violate the provisions of this section shall be fined not more than $10,000 or imprisoned for not more than one year, or both. Penalties.

(2) In addition to the penalties provided by paragraph (1) of this subsection, any person or persons who violate the provisions of subsection (a) shall be jointly and severally liable to the person or persons whose business has been referred in an amount equal to three times the value or amount of the fee or thing of value, and any person or persons who violate the provisions of subsection (b) shall be jointly and severally liable to the person or persons charged for the settlement services involved in an amount equal to three times the amount of the portion, split, or percentage. In any successful action to enforce the liability under this paragraph, the court may award the court costs of the action together with a reasonable attorney's fee as determined by the court.

TITLE COMPANIES

Sec. 9. (a) No seller of property that will be purchased with the assistance of a federally related mortgage loan shall require directly or indirectly, as a condition to selling the property, that title insurance covering the property be purchased by the buyer from any particular title company. 12 USC 2608.

(b) Any seller who violates the provisions of subsection (a) shall be liable to the buyer in an amount equal to three times all charges made for such title insurance. Liability.

ESCROW ACCOUNTS

SEC. 10. A lender, in connection with a federally related mortgage loan, may not require the borrower or prospective borrower—

(1) to deposit in any escrow account which may be established in connection with such loan for the purpose of assuring payment of taxes, insurance premiums, or other charges with respect to the property, in connection with the settlement, an aggregate sum (for such purpose) in excess of a sum that will be sufficient to pay such taxes, insurance premiums and other charges attributable to the period beginning on the last date on which each such charge would have been paid under the normal lending practice of the lender and local custom, provided that the selection of each such date constitutes prudent lending practice, and ending on the due date of its first full installment payment under the mortgage, plus one-sixth of the estimated total amount of such taxes, insurance premiums and other charges to be paid on dates, as provided above, during the ensuing twelve-month period; or

(2) to deposit in any such escrow account in any month beginning with the first full installment payment under the mortgage a sum (for the purpose of assuring payment of taxes, insurance premiums and other charges with respect to the property) in excess of the sum of (A) one-twelfth of the total amount of the estimated taxes, insurance premiums and other charges which are reasonably anticipated to be paid on dates during the ensuing twelve months which dates are in accordance with the normal lending practice of the lender and local custom, provided that the selection of each such date constitutes prudent lending practice, plus (B) such amount as is necessary to maintain an additional balance in such escrow account not to exceed one-sixth of the estimated total amount of such taxes, insurance premiums and other charges to be paid on dates, as provided above, during the ensuing twelve-month period: *Provided, however*, That in the event the lender determines there will be or is a deficiency he shall not be prohibited from requiring additional monthly deposits in such escrow account to avoid or eliminate such deficiency.

LIMITATIONS AND DISCLOSURES WITH RESPECT TO CERTAIN FEDERALLY RELATED MORTGAGE LOANS

SEC. 11. (a) The Federal Deposit Insurance Act is amended by adding at the end thereof the following new section:

12 USC 1831b. "SEC. 25. (a) No insured bank, or mutual savings or cooperative bank which is not an insured bank, shall make any federally related mortgage loan to any agent, trustee, nominee, or other person acting in a fiduciary capacity without the prior condition that the identity of the person receiving the beneficial interest of such loan shall at all times be revealed to the bank. Report. At the request of the Corporation, the bank shall report to the Corporation on the identity of such person and the nature and amount of the loan, discount, or other extension of credit.

"(b) In addition to other available remedies, this section may be enforced with respect to mutual savings and cooperative banks which are not insured banks in accordance with section 8 of this Act, and for such purpose such mutual savings and cooperative banks shall be held and considered to be State nonmember insured banks and the appropriate Federal agency with respect to such mutual savings and cooperative banks shall be the Federal Deposit Insurance Corporation."

(b) Title IV of the National Housing Act is amended by adding at the end thereof the following new section:

12 USC 1730f. "SEC. 413. No insured institution shall make any federally related mortgage loan to any agent, trustee, nominee, or other person acting in a fiduciary capacity without the prior condition that the identity of the person receiving the beneficial interest of such loan shall at all times be revealed to the institution. At the request of the Federal Home Loan Bank Board, the insured institution shall report to the Board on the identity of such person and the nature and amount of the loan."

12 USC 1730f note. (c) The Federal Deposit Insurance Corporation or the Federal Home Loan Bank Board as appropriate may by regulation exempt classes or types of transactions from the provisions added by this section if the Corporation or the Board determines that the purposes of such provisions would not be advanced materially by their application to such transactions.

FEE FOR PREPARATION OF TRUTH-IN-LENDING AND UNIFORM SETTLEMENT STATEMENTS

12 USC 2610.

SEC. 12. No fee shall be imposed or charge made upon any other person (as a part of settlement costs or othewise) by a lender in connection with a federally related mortgage loan made by it (or a loan for the purchase of a mobile home), for or on account of the preparation and submission by such lender of the statement or statements required (in connection with such loan) by sections 4 and 6 of this Act or by the Truth in Lending Act.

15 USC 1601 note.

ESTABLISHMENT ON DEMONSTRATION BASIS OF LAND PARCEL RECORDATION SYSTEM

12 USC 2611

SEC. 13. The Secretary shall establish and place in operation on a demonstration basis, in representative political subdivisions (selected by him) in various areas of the United States, a model system or systems for the recordation of land title information in a manner and form calculated to facilitate and simplify land transfers and mortgage transactions and reduce the cost thereof, with a view to the possible development (utilizing the information and experience gained under this section) of a nationally uniform system of land parcel recordation.

REPORT OF THE SECRETARY ON NECESSITY FOR FURTHER CONGRESSIONAL ACTION

Report to Congress.
12 USC 2612.

SEC. 14. (a) The Secretary, after consultation with the Administrator of Veterans' Affairs, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board, and after such study, investigation, and hearings (at which representatives of consumers groups shall be allowed to testify) as he deems appropriate, shall, not less than three years nor more than five years from the effective date of this Act, report to the Congress on whether, in view of the implementation of the provisions of this Act imposing certain requirements and prohibiting certain practices in connection with real estate settlements, there is any necessity for further legislation in this area.

Report to Congress.

(b) If the Secretary concludes that there is necessity for further legislation, he shall report to the Congress on the specific practices or problems that should be the subject of such legislation and the corrective measures that need to be taken. In addition, the Secretary shall include in his report—

(1) recommendations on the desirability of requiring lenders of federally related mortgage loans to bear the costs of particular real estate settlement services that would otherwise be paid for by borrowers;

(2) recommendations on whether Federal regulation of the charges for real estate settlement services in federally related mortgage transactions is necessary and desirable, and, if he concludes that such regulation is necessary and desirable, a description and analysis of the regulatory scheme he believes Congress should adopt; and

(3) recommendations on the ways in which the Federal Government can assist and encourage local governments to modernize their methods for the recordation of land title information, including the feasibility of providing financial assistance or incentives to local governments that seek to adopt one of the model systems developed by the Secretary in accordance with the provisions of section 13 of this Act.

DEMONSTRATION TO DETERMINE FEASIBILITY OF INCLUDING STATEMENTS OF SETTLEMENT COSTS IN SPECIAL INFORMATION BOOKLETS

12 USC 2613.

Report to Congress.

SEC. 15. The Secretary shall, on a demonstration basis in selected housing market areas, have prepared and included in the special information booklets required to be furnished under section 5 of this Act, statements of the range of costs for specific settlement services in such areas. Not later than June 30, 1976, the Secretary shall transmit to the Congress a full report on the demonstration conducted under this section. Such report shall contain the Secretary's assessment of the feasibility of preparing and including settlement cost range statements for all housing market areas in the special information booklets for such areas.

JURISDICTION OF COURTS

12 USC 2614.

SEC. 16. Any action to recover damages pursuant to the provisions of section 6, 8, or 9 may be brought in the United States district court for the district in which the property involved is located, or in any other court of competent jurisdiction, within one year from the date of the occurrence of the violation.

VALIDITY OF CONTRACTS AND LIENS

12 USC 2615.

SEC. 17. Nothing in this Act shall affect the validity or enforceability of any sale or contract for the sale of real property or any loan, loan agreement, mortgage, or lien made or arising in connection with a federally related mortgage loan.

RELATION TO STATE LAWS

12 USC 2616.

SEC. 18. This Act does not annul, alter, or affect, or exempt any person subject to the provisions of this Act from complying with, the laws of any State with respect to settlement practices, except to the extent that those laws are inconsistent with any provision of this Act, and then only to the extent of the inconsistency. The Secretary is authorized to determine whether such inconsistencies exist. The Secretary may not determine that any State law is inconsistent with any provision of this Act if the Secretary determines that such law gives greater protection to the consumer. In making these determinations the Secretary shall consult with the appropriate Federal agencies.

AUTHORITY OF THE SECRETARY

Rules and regulations.
12 USC 2617.

SEC. 19. (a) The Secretary is authorized to prescribe such rules and regulations, to make such interpretations, and to grant such reasonable exemptions for classes of transactions, as may be necessary to achieve the purposes of this Act.

(b) No provision of this Act or the laws of any State imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or interpretation thereof by the Secretary or the Attorney General, notwithstanding that after such act or omission has occurred, such rule, regulation, or interpretation is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.

APPENDIX B

RESIDENTIAL MORTGAGE LENDING AND CREDIT MARKETS

In any study of regulations and their effectiveness, it is important to review the sector of the economy impacted by the regulations in order to understand better what competitive forces are present in that sector and how the sector relates to the operation of the economy. This appendix provides such a perspective with respect to mortgage lending and the nation's credit markets. It is divided into two major sections: the first deals with mortgage lending in general and its operations within the credit markets and the second addresses mortgage lending among the five major private financial institutions that act to supply the vast majority of the nation's residential mortgage funds.

MORTGAGE LENDING AND CREDIT MARKETS

The credit markets are the portion of the economy that reflects the demand for and supply of loanable funds. They are divided into several key sectors that can be identified according to the borrower or use of funds, such as governments (federal, state, and local), corporations (business), households (consumer credit), bank loans, mortgages, and others. Funds are raised through the credit markets to finance the purchase of capital equipment, government expenditures, real estate, durable goods, and other items of worth that the borrower wishes to acquire now while deferring payment to the future. Funds may be borrowed for as short a time as overnight, or for up to 50 years or longer. Generally speaking, short- to intermediate-term borrowings are classified as money market transactions while long-term borrowings refer to capital market transactions.

In addition to setting mortgage interest rates, during periods of excess demand relative to supply (at existing interest rates), lenders can try to limit demand by imposing higher loan origination fees, making loans only to established customers, or restricting the number of loan applications they accept. Credit markets are both national and local in scope, depending on which markets are being considered. Markets involving government securities, corporate debt, and other large financing sources tend to be national with little or no regional differentials in prices (interest rates). Conversely, markets involving mortgages or consumer credit vary somewhat in price from region to region depending on the local supply and demand for such funds.

There is competition for the supply of funds as a function of demand both within each market and between various markets. One important point is that not all markets are equal in the eyes of investors who supply the funds. Governments, corporations, and large-scale individual borrowers have a distinct advantage over smaller borrowers in the mortgage and consumer credit markets.

Borrowers are competing for the supply of loanable funds derived from savings. Since savings represent the income that remains after consumption, the level of economic activity has a direct bearing on the supply of loanable funds. In an economic expansion (consumption and incomes are increasing), interest rates tend to rise because the supply of funds through savings falls short of rising demand. In an economic contraction (consumption is falling), the supply of loanable funds rises relative to demand, which is declining--thus reducing interest rates. Of course, inflation and other market factors can greatly distort this relationship.

Another factor impacting the supply of loanable funds is the monetary policy of the Federal Reserve Board. By controlling the supply of money (currency plus demand deposits--M1), the government has the ability to expand or contract the amount of funds lenders have available to lend. The actions of the Federal Reserve therefore affect the ability of lenders to provide funds to all credit markets, including mortgage lending.

Credit Market Debt Outstanding

Table I shows the various amounts of outstanding debt in the credit markets from 1946 through 1978. Since the beginning of the post-World War II recovery, credit market debt outstanding has grown at a compound annual rate of 7.7 percent. Following World War II, the Federal Government was the largest borrower--with outstanding debt accounting for 65 percent of the total. Mortgages, the second largest type of borrowings, accounted for only 12 percent of the total. From 1946 to 1978, the amount of outstanding debt owed by the Federal Government had an average annual compound growth rate of 3.6 percent while mortgage debt grew at a rate of 11.0 percent. As a result, at the end of 1978, mortgage loans were the largest single class of debt outstanding in the credit markets--at $1.7 trillion, or 31 percent, of the $3.8 trillion total.

The reasons for this strong growth are many. Since World War II, the U.S. economy has undergone major expansion and growth. Incomes have risen significantly, as has the standard of living. In addition, the post-war baby boom has sharply increased the need for housing. With more women in the work force, the ability of two-adult families to purchase houses has increased as has the ability of single-adult headed families. Since more women are in the work force, and the ability of two-adult families to purchase houses has increased, the number of single-adult headed families has produced even more households demanding housing. As a result, the price of housing has increased faster than consumer prices in general and is a major factor in the current inflationary environment.

Table II shows the annual amount of debt raised for the period 1946-1978. In each year since the end of World War II, the mortgage market has raised more funds than any other market. In 1978, mortgage lenders increased their holdings by $149.0 billion; this was more than the federal, state, and local governments combined. In fact, mortgages accounted for 31 percent of all funds raised in 1978.

TABLE I

TOTAL CREDIT MARKET DEBT OUTSTANDING
(Billions of Dollars)

	1946	1950	1955	1960	1965	1966	1967	1968	1969
Total Credit Market Debt	353.2	427.0	581.8	777.7	1,107.2	1,182.1	1,261.4	1,369.7	1,487.6
U.S. Government Securities	229.2	218.4	233.2	243.1	275.3	284.5	297.7	315.1	321.2
St. & Loc. Obligations	14.9	24.4	45.9	70.8	100.3	105.9	113.7	123.2	133.1
Corporate & Foreign Bonds	27.7	39.2	60.9	90.0	123.0	133.8	149.4	163.7	176.5
Mortgages	42.0	73.0	130.1	208.9	335.3	358.4	382.9	412.5	443.2
Consumer Credit	8.4	21.5	38.8	56.1	89.9	96.2	100.8	110.8	121.1
Bank Loans NEC	17.9	28.2	42.8	62.9	106.2	115.9	123.2	138.1	155.4
Open-Market Paper & RPs	.6	1.3	2.8	6.5	13.3	18.2	22.1	26.8	41.9
Other Loans	12.7	21.2	27.5	39.2	63.9	69.1	71.6	79.6	95.3

	1970	1971	1972	1973	1974	1975	1976	1977	1978
Total Credit Market Debt	1,595.2	1,749.8	1,941.6	2,192.9	2,411.1	2,621.7	2,912.4	3,306.8	3,801.5
U.S. Government Securities	343.0	373.8	397.4	425.7	459.9	558.1	646.7	730.1	825.3
St. & Loc. Obligations	144.4	161.8	176.5	191.2	207.7	223.2	242.2	271.3	301.4
Corporate & Foreign Bonds	201.6	225.7	244.2	257.5	281.1	317.3	355.0	390.7	421.9
Mortgages	473.1	526.5	603.4	682.3	742.5	801.5	889.2	1,023.5	1,172.3
Consumer Credit	127.1	140.1	157.2	181.0	191.3	200.6	224.2	259.2	339.3
Bank Loans NEC	161.6	173.7	201.5	253.1	291.4	277.3	282.9	314.7	344.5
Open-Market Paper & RPs	41.8	42.6	46.7	68.0	82.8	80.4	93.7	113.4	155.9
Other Loans	102.7	105.6	114.7	134.0	154.5	163.3	178.6	203.8	240.7

Source: Federal Reserve Board

TABLE II

TOTAL CREDIT MARKET DEBT RAISED
(Billions of Dollars)

	1946	1950	1955	1960	1965	1966	1967	1968	1969
Total Debt Instruments	-4.9	26.6	41.3	40.4	80.4	76.6	80.4	109.0	116.4
U.S. Government Securities	-23.2	.8	.2	-1.7	3.9	9.2	13.2	17.4	6.2
St. & Loc. Obligations	.1	3.3	5.3	5.3	7.3	5.6	7.8	9.5	9.9
Corporate & Foreign Bonds	1.0	2.3	3.6	5.4	8.1	11.2	16.6	14.4	13.8
Mortgages	6.2	10.1	16.2	17.1	27.4	22.7	24.6	29.8	30.7
Consumer Credit	2.7	4.1	6.4	4.6	9.6	6.4	4.5	10.0	10.8
Bank Loans NEC	5.3	6.0	88.0	4.2	16.4	9.7	7.3	14.8	16.8
Open-Market Paper & RPs	.3	.2	-.1	2.2	1.1	4.9	3.9	4.8	12.5
Other Loans	2.7	1.4	1.8	3.4	6.5	6.9	2.5	8.3	15.8

	1970	1971	1972	1973	1974	1975	1976	1977	1978
Total Debt Instruments	108.4	153.4	189.3	238.8	226.4	212.8	284.1	388.5	478.0
U.S. Government Securities	21.7	30.9	23.6	28.3	34.3	98.2	88.1	84.3	95.2
St. & Loc. Obligations	11.2	17.4	14.7	14.7	16.5	16.1	15.7	23.7	28.3
Corporate & Foreign Bonds	23.3	23.5	18.4	13.6	23.9	36.4	37.2	36.1	31.6
Mortgages	29.9	52.5	76.8	79.9	60.5	57.2	87.1	134.0	149.0
Consumer Credit	5.4	14.7	19.8	26.0	9.9	9.7	25.6	40.6	50.6
Bank Loans NEC	7.3	11.0	26.1	48.8	41.0	-12.2	7.0	29.8	58.4
Open-Market Paper & RPs	2.1	-.1	1.6	8.3	17.7	-1.2	8.1	15.0	26.4
Other Loans	7.5	3.5	8.4	19.1	22.7	8.7	15.3	25.2	38.6

Source: Federal Reserve Board

Mortgage Debt Outstanding

The category "mortgages" includes more than loans to purchase residences. It also includes loans to purchase farms, stores, and office buildings (commercial) and consruction loans.

Because RESPA is concerned with one-to-four unit mortgage loans, it is necessary to look at how this class of mortgage relates to the credit markets. Table III shows the mortgage debt outstanding, broken down according to property type. At the end of 1978, one-to-four family residential mortgages amounted to $761.9 billion, or 55 percent, of total mortgage debt. Relating this to total credit market debt outstanding reveals that only the Federal Government accounted for a larger amount of outstanding debt. Of the $149.0 billion in funds raised for mortgage lending in 1978, $105.3 billion, or 70.7 percent, went into single family (one-to-four unit) mortgages. This was the largest class of funds raised--exceeding the $95.2 billion in funds raised by the U.S. Government.

All of the above data indicate that mortgage lending attracts massive amounts of funds compared with other sectors of the credit markets. The fact that mortgage demand is derived from the demand for houses, stores, office buildings, farms, and other real property points to the growth in this sector of the economy.

Private financial institutions provide the vast majority of credit market funds that go into mortgage lending. In 1978, private institutions supplied $103.3 billion, or 69.3 percent, of the total amount of funds raised. Of this amount commercial banks, savings and loan associations, life insurance companies, and mutual savings banks accounted for almost 100 percent of the net increase. These institutions depend on deposits--or, in the case of life insurance companies, on policy premiums--as their main source (supply) of new loanable funds. All other private financial institutions, including credit unions, private pensions funds, finance companies, and real estate investment trusts, raised a net total of only $500 million in new mortgage funds in 1978. In addition to these institutions, mortgage banking companies, channel a significant amount of funds into mortgage investments and will also be discussed.

Non-financial institutions raised $45.7 billion in new mortgage funds in 1978. This group includes households (individuals), state and local government general funds, the Federal Government, government-sponsored credit agencies, and mortgage pools. By far the largest provider of new funds in this group were government pools, which accounted for 18.3 percent of this total. These pools include mortgage-backed securities such as GNMA pass-throughs and FHLMC participation certificates. The mortgage-backed securities market will be discussed in greater detail in the secondary market section. Households which are individuals that hold or make mortgage loans, were the second largest provider of mortgages in this group in 1978, with $14.5 billion; sponsored credit agencies, including the Federal Home Loan Bank System, contributed $12.2 billion.

TABLE III

TOTAL MORTGAGE DEBT OUTSTANDING
(Billions of Dollars)

	1946	1950	1955	1960	1965	1966	1967	1968	1969
Total All Holders	42.0	73.0	130.1	208.9	335.3	358.4	382.9	412.5	443.2
By Property Type									
1-to-4 Family	23.0	45.2	88.2	141.9	220.5	232.9	247.2	264.6	282.7
Multifamily	5.3	9.3	13.5	20.8	38.2	41.3	44.8	48.3	53.2
Non-residential	13.7	18.5	28.4	46.2	76.7	84.2	90.8	99.7	107.4

	1970	1971	1972	1973	1974	1975	1976	1977	1978
Total All Holders	473.1	526.5	603.4	682.3	742.5	801.5	889.3	1,023.5	1,172.5
By Property Type									
1-to-4 Family	297.7	328.3	372.2	416.2	449.4	490.8	556.6	656.6	761.9
Multifamily	60.1	70.1	82.8	93.1	100.0	100.6	104.5	111.8	122.0
Non-residential	115.3	128.1	148.5	173.0	193.1	210.2	228.3	255.1	288.6

Source: Federal Reserve Board

Mortgage debt outstanding consists of three types of mortgages: insured by the Federal Housing Administration (FHA); guaranteed by the Veterans Administration (VA); and conventional, which can be either insured by private mortgage insurance or uninsured. From 1946 to 1967, the proportion of conventional mortgages to total single-family mortgage holdings grew from about 56 to 67 percent. Since 1967, conventional single-family lending has undergone strong growth: in 1978 conventional mortgages accounted for more than 80 percent of all single-family mortgage debt. Private mortgage insurance on conventional loans has risen from less than $300 million in 1960 to over $81 billion in 1978, or about 10.7 percent of all single-family mortgages. These data show that over two-thirds of the single-family mortgage debt held in 1978 was uninsured and that conventional mortgage lending has experienced strong growth, especially since 1967.

Mortgage Lending at Financial Institutions

A closer look at the four financial institutions that advance significant amounts of new funds for mortgage investments will provide better insight into the financial operations of the primary mortgage market. As noted above, financial institutions (except life insurance companies) depend on deposits (savings, time and, in the case of commercial banks, demand) as their main source of new funds. To attract deposits, these institutions are in competition with other borrowers for the savings capital (deposits) of households and organizations. The success or failure of financial institutions in attracting deposits has a significant bearing on the supply of funds going into mortgage investments. Two key factors influence the flow of deposits: the absolute amount of potential deposit funds (savings) in the economy, that is, the funds remaining after consumption; and the rate of return on alternative investments available to the potential depositor relative to the rate offered by the particular financial institution. The level of potential deposits is a function of the growth rate in the economy, the personal savings rate, and expectations about future economic conditions. The rate of return on alternative investments, the amount of income that can be received by the potential depositor from investing in other areas (credit markets) instead of savings accounts, plays a key role in determining the level of funds going into mortgage lending institutions. These alternatives include short- and intermediate-term Treasury securities, stocks, investment funds, money market funds, the futures market, or holding the funds out of circulation.

Federal regulations (Regulation Q, for example) limit the level of interest that depository institutions can pay to depositors. This reduces the effectiveness of depository institutions in competing for funds, especially in periods of high or rising short-term interest rates. This situation is illustrated by Table II, which shows the amount of funds raised in the credit markets by type of debt, and Table IV which shows the yields on 90-day Treasury bills--a recognized indicator of short-term credit market conditions and a competing investment for savings deposits. In 1973, the Treasury bill rate rose to an average for the year of 7.03 percent from 4.07 percent in 1972. As a result savings flows for all three institutions (excluding large CDs at commercial banks) dropped from $75.8 billion to $54.6 billion. This decrease in

TABLE IV

SECURITY YIELDS AND RATES

	U.S. Government					Mortgages	
						Conventional	
Year	3.Mo. Treasury Bills	5 Year	20 Year	Aaa Corporate Bonds	FHA-Insured[1]	New Homes	Existing Homes
1970	6.39	7.38	6.86	8.04	9.03	8.52	8.56
1971	4.33	5.99	6.12	7.39	7.70	7.75	7.83
1972	4.07	5.98	6.01	7.21	7.53	7.64	7.70
1973	7.03	6.87	7.12	7.44	8.19	8.30	8.33
1974	8.84	7.80	8.05	8.57	9.55	9.22	9.23
1975	5.80	7.77	8.19	8.83	9.19	9.01	9.21
1976	4.98	7.18	7.86	8.43	8.82	8.99	9.11
1977	5.27	6.99	7.67	8.02	8.68	9.01	9.02
1978	7.19	8.32	8.48	8.73	9.70	9.54	9.58

[1] Secondary Market Yield

savings flows reduced funds available for mortgage lending, as net new mortgage funds at depository institutions dropped from $54.1 billion in 1972 to $52 billion in 1973. The following year, 90-day Treasury bills rose to 7.84 percent, on average, which further reduced net savings flows at these institutions and was a major factor of the decrease in net mortgage funds at depository institutions from $52.0 billion to $32.6 billion. Total net new mortgage funds fell from $79.9 billion to $60.5 billion for all mortgage investors between year-end 1973 and year-end 1974.

It is interesting to note that during the 1973-1975 period of economic contraction and high interest rates, funds raised in the credit markets (Table II) dropped for small borrowers--such as mortgagors, consumers, bank loan borrowers, etc.--and increased for large borrowers--such as the Federal Government, state and local governments, and corporations. This suggests that large borrowers are superior to small borrowers in obtaining funds during tight money periods. Consequently, mortgage lending tends to go through fairly severe periods of reduced supply when credit market conditions become tight.

Recent liberalization of interest rate regulations and the introduction of money market certificates have helped depository institutions to compete for deposits with alternative investments; however, these factors have also raised the cost of funds at these institutions. For example, the average cost of funds at FSLIC-insured S&Ls rose to 6.79 percent in the last half of 1978, as compared with 6.48 percent for the same period in 1977 and 6.34 percent in 1975. The cost of funds is a significant factor in determining mortgage rates.

Other sources of loanable funds at depository financial institutions include loan principal repayments on existing mortgages and other loans. These repayments are divided between normal amortization and prepayments. During periods in which short-term interest rates are high or rising and the economy is slowing down, amortization payments are reduced through increased delinquency while prepayments are held down due to a lack of funds for mortgages to finance purchases of new homes and other real estate. In addition to repayments, financial institutions can borrow funds through various sources. These borrowed funds are not a primary source of new loanable funds.

Mortgage loans are but one kind of investment accessible by financial institutions. Except for the S&L industry, institutional mortgage investors have significant investment options. Because of these alternatives, mortgages must provide yields that are competitive with other investments. Table IV shows yield on various government and corporate long-term debt for the period 1970-1978. As can be seen, the yields on mortgages, both FHA-insured secondary market and conventionals, are significantly higher for the period than government or corporate yields. The yield spread between conventional mortgages, corporate, and long-term government securities tended to decline over the 1973-75 recession, as mortgage lenders were less able to compete with governments or corporations. This was the result of a number of factors, including: the willingness of home or property purchasers to pay the higher interest rates; state usury law ceilings, which in many areas held down the interest rates lenders could charge borrowers; and Regulation Q, which limited the rates offered to savers to attract deposits--thus making higher mortgage rates useless in attracting additional supply.

Mortgage Interest Rates

The interest rate is the price of a mortgage loan (or any other type of loan). It can be broken down into several "cost" components. The largest component is the cost of funds to the lending institutions, or the cost of attracting funds from investors. Operating costs also account for a significant, although smaller, portion of the rate to be charged. A third component is profit to the lender, which can exhibit wide savings over economic and interest rate cycles. In addition to the interest rate, there may by additional charges such as origination fees, that may be used to restrict mortgage demand. In periods of excess supply, mortgage rates tend to fall toward the level set by the cost of funds and operating expenses. During periods of excess demand, lenders--to the extent permitted by regulations--must ration their available supply of funds through interest rate increases, higher fees and points, and other restrictions on loan applications. When the supply of funds is tight, the cost of obtaining new funds to lend will rise rapidly and to a relatively high level compared with yields on the lender's existing mortgage portfolio. This high cost of funds has a significant impact on new mortgage rates.

For lenders to continue to originate new mortgage debt, the yield to mortgage lenders/investors must be as good as or better than other investment alternatives. S&Ls are the only major mortgage lending institutions that have significant restrictions on their investment alternatives outside of mortgages. They are also restricted in the methods they can use to attract funds. Thus, when interest rates rise to a level that diverts savings deposits from S&Ls, the net effect is somewhat higher mortgage rates (because of their reduced ability to compete for funds) and significantly reduced growth in mortgage lending.

The level of yield required to equate supply with demand can be a single interest rate or some combination of interest rates and front-end fees, or points, on loans. One point is equal to 1 percent of the loan amount and is considered interest when determining the yield on a mortgage. For example on a $30,000, 9 percent mortgage, one point would equal $300 and would raise the yield (effective interest rate) on the mortgage from 9 percent to 9.12 percent if held to its 30-year maturity.

The method used in setting yields varies between conventional and FHA/VA mortgages. The ability of lenders to set mortgage rates and charge points due to state usury laws also varies significantly.

FHA/VA mortgages work on a discount or point system, whereby the FHA sets the ceiling rate lenders can charge for a mortgage. If that ceiling rate is below local market rates, lenders will charge points (front-end interest payments) to the seller to bring the yield up to the required level. Table IVA shows the ceiling rates on FHA/VA mortgages for the period 1975-1978. The points shown in column 2 of the table represent the number of points required,

TABLE IVA

MORTGAGE YIELDS
(Percent)

Year/	Month	FHA/VA		Conventional			FMNA Auction Results	
		Mortgage Interest Rate Ceiling	Points[1]	Mortgage Contract Rate	Points[2]	Effective[3] Mortgage Rate	FHA/VA	Conventional
1975	1	8.50	3.54	9.11	.54	9.20	9.23	9.46
	2	8.50	2.91	9.07	.52	9.15	8.92	9.12
	3	8.00	5.84	9.08	.52	9.15	8.84	8.98
	4	8.50	7.27	8.83	.57	8.93	9.08	9.20
	5	8.50	5.38	8.81	.54	8.90	9.28	9.42
	6	8.50	4.08	8.78	.52	8.87	9.08	9.21
	7	8.50	4.41	8.83	.52	8.91	9.14	9.23
	8	8.50	6.08	8.79	.52	8.88	9.38	9.46
	9	9.00	5.15	8.87	.50	8.96	9.76	9.83
	10	9.00	6.07	8.85	.54	8.94	9.91	9.96
	11	9.00	2.27	8.86	.54	8.96	9.33	9.44
	12	9.00	2.14	8.94	.53	9.03	9.31	9.37
1976	1	8.75	2.38	8.96	.48	9.06	9.09	9.25
	2	8.75	2.15	8.88	.59	8.98	9.06	9.16
	3	8.50	2.08	8.86	.58	8.96	9.05	9.14
	4	8.50	2.68	8.75	.48	8.84	8.88	9.02
	5	8.50	3.84	8.73	.48	8.81	9.05	9.17
	6	8.50	4.58	8.69	.43	8.78	9.18	9.31
	7	8.50	3.78	8.69	.48	8.77	9.04	9.25
	8	8.50	3.42	8.67	.46	8.74	8.96	9.15
	9	8.50	2.72	8.74	.44	8.81	8.88	9.11
	10	8.00	3.29	8.67	.47	8.75	8.79	9.04
	11	8.00	4.70	8.68	.44	8.76	8.67	9.00
	12	8.00	3.24	8.67	.38	8.74	8.48	8.85
1977	1	8.00	3.37	8.64	.50	8.72	8.47	8.82
	2	8.00	3.90	8.59	.52	8.68	8.58	8.88
	3	8.00	4.79	8.56	.46	8.63	8.68	8.91
	4	8.00	4.87	8.54	.47	8.62	8.69	8.97
	5	8.50	4.10	8.56	.46	8.64	8.74	9.08
	6	8.50	1.90	8.56	.58	8.64	8.75	9.12
	7	8.50	1.53	8.53	.42	8.60	8.72	9.07
	8	8.50	1.81	8.54	.43	8.61	8.76	9.06
	9	8.50	1.70	8.57	.46	8.64	8.74	9.06
	10	8.50	2.31	8.59	.50	8.67	8.83	9.11
	11	8.50	2.47	8.56	.48	8.64	8.85	9.16
	12	8.50	3.16	8.57	.48	8.66	8.98	9.19
1978	1	8.50	4.58	8.61	.57	8.70	9.16	9.32
	2	8.75	5.94	8.63	.58	8.72	9.31	9.49
	3	8.75	4.12	8.65	.54	8.74	9.36	9.61
	4	8.75	4.70	8.69	.48	8.76	9.44	9.71
	5	9.00	5.56	8.70	.44	8.83	9.67	9.90
	6	9.50	6.14	8.75	.52	8.84	9.94	10.09
	7	9.50	3.46	8.86	.50	8.94	10.02	10.19
	8	9.50	2.03	8.96	.58	9.04	9.80	10.10
	9	9.50	1.81	9.06	.50	9.15	9.78	10.02
	10	9.50	3.89	9.23	.51	9.32	10.06	10.20
	11	9.50	5.22	9.28	.54	9.37	10.29	10.56
	12	9.50	6.58	9.30	.53	9.41	10.51	10.82

[1] Points required to equate FHA rate to FNMA Auction rate for FHA/VA mortgages.

[2] Average points charged.

[3] Effective primary market rate.

given the ceiling rate, to bring the yield on FHA/VA mortgages up to the FNMA auction level in column 6 (yield required to sell the loans in the secondary market). Points are paid at settlement and are a cost of financing a real estate transaction when government insurance or guarantees are involved. On FHA/VA loans, the home buyer (mortgagor) can only pay one point; the seller pays the balance. As column 2 shows, the number of points can fluctuate greatly over time, depending on the FHA ceiling and market conditions, because charging points is the only method available for lenders to obtain market yields on FHA/VA mortgages. This can result in a major expense when a home is sold to a buyer who has FHA/VA financing and can often lead to a higher asking price for the home.

Conventional mortgages differ from FHA/VA mortgages in that lenders can set both the interest rates and the point level to achieve the required yield. Column 3 in Table IVA shows conventional mortgage rates; column 4 shows average points charged; and column 5 shows the effective yield after the points are added to interest income. The level of mortgage rates fluctuates constantly, as do the points charged, reflecting market conditions. It should be noted that the variation in the level of conventional points is not nearly as great as in FHA/VA points because of the lender's ability to adjust interest rates. Of course, the ability of lenders to set rates and points is controlled by state usury laws. When these laws come into effect, they limit mortgage yields; this causes lenders to switch to FHA/VA loans, when they are exempt from the law, or withdrawn from mortgage lending all together. Several states prohibit charging points on conventional mortgages. In the states that do allow it, the industry practice is to charge 1 to 2 points.

The difference between the FNMA conventional auction yields (column 7) and the effective conventional mortgage rate shows the difference between the secondary market and the primary market. Because the majority of FHA/VA loans originated are through mortgage bankers who sell all the loans they originate, the point structure shown in this table is fairly close to actual experience. The conventional mortgage rates shown represent averages for the U.S. and are well below FNMA yields; this is because the majority of conventional secondary market mortgage sales come from areas of this country characterized by tight mortgage markets, resulting in higher mortgage rates than a national average.

PRIVATE MORTGAGE LENDING

This appendix reviews the five major private financial institutions active in mortgage lending (savings and loan associations, commercial banks, mortgage banking companies, mutual savings banks, and life insurance companies) and examines each of their roles in holding mortgage debt and in mortgage origination. It also discusses the role of mortgage servicing and the secondary market in the lending process.

Mortgage Debt Outstanding by Institution

Table V presents data on mortgage debt held by the four major financial intermediaries and all other holders, by property type, for the period 1946

TABLE V

MORTGAGE HOLDINGS BY TYPE OF INSTITUTION
(Billions of Dollars)

	1946	1950	1955	1960	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978
S&L Total	7.1	13.7	31.4	60.1	110.3	114.4	121.7	130.6	140.0	149.8	174.3	206.2	231.7	249.3	278.6	323.1	381.2	432.9
1-to-4 Family	6.8	13.1	30.0	55.4	94.2	97.4	103.2	110.1	117.7	124.5	141.7	166.4	187.1	201.0	223.9	260.9	310.7	366.2
Multifamily	.1	.2	.6	2.2	8.1	8.6	9.5	10.5	11.7	13.8	17.6	21.2	22.8	23.8	25.5	28.4	32.5	36.1
Non-residential	.2	.3	.8	2.5	8.0	8.4	9.0	10.0	10.6	11.5	15.0	18.7	21.9	24.5	29.2	33.8	38.0	40.6
Commercial Banks-Total	7.2	13.7	21.0	28.8	49.7	54.4	58.9	65.5	70.5	72.8	82.5	99.3	119.1	132.1	136.2	151.3	179.0	214.0
1-to-4 Family	4.6	9.5	15.1	19.2	30.4	32.8	35.3	38.8	41.4	42.3	48.0	57.0	68.0	74.8	77.0	86.2	105.1	127.0
Multifamily	.8	1.0	.8	1.1	2.0	2.1	2.4	2.7	3.2	3.3	4.0	5.8	6.9	7.8	5.9	8.1	9.2	10.9
Non-residential	2.1	3.2	5.1	8.4	17.3	19.5	21.2	24.0	25.9	27.1	30.5	36.6	44.1	49.7	53.3	57.0	64.7	76.1
Mutual Savings Banks-Total	4.4	8.3	17.5	26.9	44.6	47.3	50.5	53.5	56.1	57.9	62.0	67.6	73.2	74.9	77.2	81.6	88.1	95.2
1-to-4 Family	2.0	4.3	11.8	20.6	33.8	35.6	37.7	39.5	41.1	42.1	43.4	46.2	48.8	49.2	50.0	53.1	57.6	62.3
Multifamily	1.6	2.7	3.7	3.7	6.3	6.6	7.0	7.3	7.6	7.8	9.6	10.9	12.3	12.9	13.8	14.2	15.3	16.5
Non-residential	.9	1.2	1.9	2.6	4.5	5.1	5.8	6.7	7.4	8.0	9.0	10.5	12.1	12.8	13.4	14.3	15.2	16.4
Life Insurance Co.-Total	7.2	16.1	29.4	41.8	60.0	64.6	67.5	70.0	72.0	74.4	75.5	76.9	81.4	86.2	89.2	91.6	96.8	105.9
1-to-4 Family	2.5	8.5	17.7	24.9	29.6	30.2	29.8	29.0	27.6	26.8	24.6	22.3	20.4	19.0	17.6	16.1	14.7	14.4
Multifamily	1.5	2.6	3.6	3.9	8.8	10.3	11.7	12.8	14.2	16.0	16.7	17.3	18.5	19.6	19.6	19.2	18.8	19.0
Non-residential	3.1	5.0	8.2	13.0	21.6	24.1	26.1	28.2	30.2	31.6	34.1	37.3	42.5	47.6	52.0	56.3	63.3	72.5
Other-Total	16.1	21.2	30.8	51.3	70.7	77.7	84.3	92.9	104.6	118.2	132.2	153.4	176.9	200.0	220.3	241.7	278.4	324.5
1-to-4 Family	7.1	9.8	13.6	21.8	32.5	36.9	41.2	47.2	54.9	62.0	70.6	80.3	91.9	106.4	122.3	140.3	168.6	202.0
Multifamily	1.6	2.6	4.8	9.9	13.0	13.7	14.2	15.0	16.5	19.2	22.2	27.7	32.6	35.9	35.8	34.6	36.0	39.5
Nonresidential	7.4	8.8	12.4	19.7	25.3	27.1	28.7	30.8	33.3	37.1	39.6	45.4	52.4	58.5	62.3	66.9	73.9	83.0
All Holders-Total	42.0	73.0	130.1	208.9	335.3	358.4	382.9	412.5	443.2	473.1	526.5	603.4	682.3	742.5	801.5	889.3	1,023.5	1,172.5
1-to-4 Family	23.0	45.2	88.2	141.9	220.5	232.9	247.2	264.6	282.7	297.7	328.3	372.2	416.2	449.4	490.8	556.6	656.6	771.9
Multifamily	5.3	9.3	13.5	20.8	38.2	41.3	44.8	48.3	53.2	60.1	70.1	82.8	93.1	100.0	100.6	104.5	111.8	122.0
Non-residential	13.7	18.5	28.4	46.2	76.7	84.2	90.8	99.7	107.4	115.3	128.1	148.5	173.0	193.1	210.2	229.3	255.1	288.6

Source: Federal Reserve Board

to 1978. As noted above, mortgage debt in this 32-year period grew at an 11-percent compound annual rate. Single-family debt for the same period grew at an 11.6-percent annual rate.

S&Ls are the largest holders of mortgage debt--accounting for almost 40 percent of the $1.17 trillion outstanding at the end of 1978. Over the period 1946 to 1978, S&L mortgage holdings have grown at an annual rate of 13.7 percent, and at 14.2 percent since 1970. S&Ls are also the largest holders of single-family and multi-family (5 or more unit) mortgages. Single family holdings of S&Ls at the end of 1978 accounted for 46.8 percent of total single-family mortgage debt in the U.S.; multi-family holdings accounted for 30 percent. S&L mortgage holdings have grown faster than any other financial intermediary since 1946.

The second largest holders of mortgage debt are commercial banks--accounting for 18.3 percent of the year-end 1978 outstanding amount. Commercial banks are the largest institutional holders of non-residential mortgage debt. Banks' holdings of mortgage debt have grown at an 11.2 percent compound annual rate since 1946, and at 14.4 percent since 1970--the fastest of any intermediary. Banks are the second largest holders of single-family mortgages but hold less than 9 percent of the multi-family loans outstanding.

Life insurance companies (LICs) were the third largest holder of mortgage debt at year-end 1978--accounting for 9 percent of the total. Since 1946, LICs have experienced the slowest growth in holdings of any financial intermediary--with an annual growth rate of only 8.8 percent. LIC holdings of single-family mortgages have been declining since 1966, and in 1978 amounted to only 1.2 percent of the U.S. total. The vast majority of LIC mortgage holdings are in non-residential loans, which make up 68.5 percent of their holdings. Multi-family holdings have grown at only a 2.2 percent annual rate since 1970, as life insurance companies have opted to invest more heavily in real estate itself rather than in the mortgages that finance it.

The smallest of the four financial intermediary holders of mortgage debt are mutual savings banks (MSBs). Their holdings at the end of 1978 came to $95.2 billion, or 8.1 percent of the total. MSB holdings since 1946 have grown at an annual rate of 10.1 percent, and at only 6.4 percent since 1970. MSBs are the third largest holder of single-family mortgages, and holdings of multi-family and non-residential mortgages are each equal to about 17 percent of mortgage holdings. Although mutuals are not as diverse as commercial banks or life insurance companies in their investments outside of mortgages they have experienced greater growth in recent years in non-mortgage investments than in mortgages. Both life insurance companies and mutual savings banks acquire a large percentage of their mortgage holdings through secondary market purchases.

All other holders of mortgage debt accounted for 27.7 percent of the total amount outstanding at the end of 1978. Of this amount, $202 billion, or 62.2 percent, were in single-family mortgages. Non-residential mortgages accounted for 25.6 percent of 1978 holdings; multi-family holdings made up the remaining 12.2 percent. Since 1946, this group of holders has grown at a compound annual rate of 9.8 percent; however, this group includes mortgage pools and trusts associated with mortgage-backed securities which, since 1970, have been the fastest growing class of mortgage holdings.

Mortgage Originations by Institution

Considerable differences exist among the five major private institutions that advance mortgage funds in how those funds are advanced and how mortgages are acquired. Mortgages can be acquired by two methods: primary market origination or purchase in the secondary market. Table VI shows mortgage originations for the United States from 1970 to 1978, and the five major private lenders as estimated by the Department of Housing and Urban Development (HUD). These data are broken down by property type to show the extent to which lenders are involved in one-to-four family mortgages and thus come under the provisions of RESPA.

From 1970 to 1978, mortgage originations by the 11 major lending groups rose from $59.8 billion to $243.9 billion. The volume of originations increased in each year of the period except 1974--the middle of the 1973-75 recession--when originations declined 12.7 percent from the 1973 level.

As a percentage of total mortgage originations, one-to-four family loans accounted for over 72 percent of originations in 1978--up from 59 percent in 1970. The increase in the percent of single-family originations has been fairly constant since 1970. This has been due, in part, to the resurgence in conventional residential mortgage lending versus FHA-insured and VA-guaranteed lending. In 1970, conventional loans accounted for 64.6 percent of one-to-four family originations. By the end of 1978, this percentage had grown to 85.7 percent. In terms of dollar originations, FHA/VA single-family loans since 1970 have grown from $12.6 billion to $25.3 billion; conventional lending has increased from $23.0 billion to more than $151 billion.

Savings and loan associations are the largest originators of mortgage loans, including single-family loans, in the United States. Originations are made with the general intent of holding the loans in the institution's asset portfolio, as opposed to selling them in the secondary market. S&Ls accounted for 41.7 percent of all originations and 50.9 percent of single-family originations in 1978.

The second largest mortgage originators are commercial banks, with a 25.7 percent share of 1978 total originations and 23.4 percent of the single-family originations. Like S&Ls, commercial banks originate loans largely for their own investment portfolios. Unlike S&Ls, however, commercial banks have the majority of their assests in non-mortgage investments and a significant portion of their mortgage originations in non-residential loans.

Mortgage banking companies are the third largest originators of mortgages and, unlike S&Ls or commercial banks, they originate loans exclusively to be sold to other investors. Practically the only mortgages held by mortgage bankers are those being accumulated until their volume is sufficient to be

TABLE VI

MORTGAGE ORIGINATIONS BY TYPE OF LENDER
(Millions of Dollars)

	1970	1971	1972	1973	1974	1975	1976
Total-all Lender Groups	59,832	93,739	121,625	127,673	111,402	120,715	197,061
1-to-4 Home	35,587	57,788	75,864	79,126	67,513	77,942	132,011
Multifamily	8,784	12,465	15,427	14,022	12,264	10,677	18,369
Non residential	15,461	23,456	30,335	34,525	31,625	32,096	46,682
S&L Total	18,300	33,770	46,292	46,830	37,822	49,768	89,513
1-to-4 Family	14,814	26,603	36,739	38,441	30,932	41,201	74,875
Multifamily	1,924	3,711	5,285	4,171	3,252	3,562	6,971
Non residential	1,562	3,457	4,268	4,218	3,637	5,005	7,667
Commercial Banks-Total	13,568	21,982	31,173	33,568	28,775	27,100	53,653
1-to-4 Family	7,797	12,599	17,710	18,782	16,128	14,489	28,555
Multifamily	324	726	1,347	1,122	749	766	4,615
Non residential	5,448	8,658	12,116	13,663	11,898	11,845	20,483
Mutual Savings Banks-Total	4,316	7,036	9,363	10,491	7,051	7,156	10,647
1-to-4 Family	2,147	3,540	5,052	5,912	3,929	4,339	7,100
Multifamily	1,140	1,870	1,929	2,088	1,532	1,477	1,581
Non residential	1,029	1,625	2,381	2,491	1,589	1,340	1,966
Life Insurance Co.-Total	5,843	6,263	7,483	9,975	9,813	8,228	8,956
1-to-4 Family	334	334	401	380	363	252	375
Multifamily	2,238	1,706	1,826	2,293	2,043	1,137	795
Non residential	3,271	4,222	5,257	7,302	7,406	6,839	7,787
Mortgage Banking Co.-Total	11,842	16,425	17,615	14,251	14,375	15,933	19,859
1-to-4 Family	8,906	12,487	13,326	12,657	13,026	13,994	16,815
Multifamily	1,433	1,960	2,698	928	596	779	1,202
Non residential	1,503	1,978	1,591	686	755	1,160	1,843
All other Originations-Total	5,963	8,263	9,699	12,558	13,566	12,530	14.433
1-to-4 Family	1,589	2,227	2,636	2,954	3,135	3,667	4,291
Multifamily	1,725	2,480	2,342	3,420	4,093	2,956	3,205
Non residential	2,648	3,556	4,722	6,185	6,340	5,907	6,936

Source: Department of Housing and Urban Development sold. Because of this, mortgage bankers do not appear in the table on loan holdings; however, they are a significant intermediary through which mortgage investors can operate. The HUD data show that in 1978, mortgage bankers accounted for 12.8 percent of total and 16.2 percent of single-family originations. About two-thirds of single-family originations were in FHA/VA mortgages, compared with only 5 percent for banks and less than 3 percent for S&Ls. Despite this high percentage of FHA/VA lending, conventional single-family originations by mortgage bankers have risen from less than 5 percent in 1969, indicating a growing involvement in nongovernment-insured mortgages.

The fourth largest originators of mortgages are mutual savings banks. They originate mortgages for their own investment portfolios, and their lending is concentrated in the conventional area. Mutuals accounted for 5.2 percent of total 1978 originations and 5.3 percent of single-family originations. Since 1970, mortgage acquisitions have risen much more slowly at MSBs than at any other private financial institutions except life insurance companies. This is at least partly due to the geographic concentration of MSBs in the Northeast, which generally has a weak level of real estate activity.

The HUD data show that life insurance companies originated $14.9 billion in mortgages in 1978, with less than $1.0 billion going into single-family mortgages. The vast majority of their originations are non-residential loans. About 60 percent of LIC single-family originations were in conventional loans. Mortgages are originated or acquired primarily to go into the asset holdings of the company.

All other major 1978 originating groups accounted for only 7.5 percent of the total. This excludes individuals, credit unions, and other lenders that are too difficult or too small to estimate. Of the $18.2 billion in mortgages made by other lenders, non-residential loans accounted for 47.2 percent of the total, followed by single-family loans at 35.6 percent.

Secondary Mortgage Market

The secondary mortgage market provides a marketplace for buying and selling mortgage loans once they have been originated in the primary market. This market is not well-defined and does not exist as a separate institution such as the New York Stock Exchange. It is a loosely knit, highly fragmented market pulled together to some extent by such national secondary market organizations as FNMA, FHLMC, and GNMA. Any institution wishing to purchase or sell a mortgage can participate in the market. The types of mortgages or mortgage-backed securities that can be traded include: whole loans (FHA, VA, and conventional); private-issue mortgage participations; and mortgage-backed securities (including GNMA passthrough securities, FHLMC participation certificates, private-issue mortgage passthrough securities, and private-issue mortgage-backed bonds).

The secondary market exists to facilitate the flow of funds from capital surplus mortgage markets to capital deficit markets. Local markets or regions that tend to have heavy loan demand relative to the supply of funds tend to be sellers of mortgages and mortgage-backed securities in the secondary market; areas with weak mortgage loan demand relative to supply tend to be net purchasers in the secondary market. Another function of the market is to channel funds into mortgage lending from non-traditional mortgage lending sources. Since the late 1960s, the Federal Government has worked to develop and expand the secondary market by creating agencies that purchase mortgages or guarantee securities that can be sold to non-traditional mortgage lenders. The three main examples of this type of agency are FNMA, FHLMC, and GNMA. Each agency works to expand the supply of funds available to mortgage lenders by purchasing or helping market (GNMA) existing loans. The proceeds from these operations can be used to create additional mortgages.

HUD data show that in 1978 secondary market sales of mortgages by 11 mortgage lending groups amounted to $70.2 billion, and purchases came to $72.1 billion (see Table VII). Of the five major private financial intermediaries involved in mortgage lending, three (S&Ls, commercial banks, and mortgage bankers) sold more loans than they purchased. In fact, for all five lenders, 1978 sales totaled $53.8 billion--compared with purchases of only $21.2 billion. To the extent that these sales were made to non-mortgage lenders, the supply of mortgage funds was expanded.

Table VIII shows, by type of institution, the purchase and sales activity of the five major lending groups for single-family mortgages as well as total single-family secondary market activity for all 11 lending groups. It should be noted that single-family sales amounted to $60.2 billion in 1978, and accounted for 85.8 percent of all sales; single-family purchases totaled $62.1 billion or 86.1 percent of secondary market purchases.

Mortgage bankers, who sell practically all of the loans they originate, are the largest single group of mortgage sellers--at $28.4 billion. Savings and loan associations, the largest single-family originators, are second and accounted for about $15 billion in sales in 1978. Commercial banks are third, with sales of $5.8 billion. These three groups accounted for 81.2 percent of 1978 originations.

As with all secondary markets, the volume data represent the total volume of transactions. Because of this, there is double and triple accounting of the actual number of loans sold and purchased. For example, say an S&L originates a mortgage and sells it to the FHLMC which, they in turn, use the loan to back a passthrough security sold to investors. This represents two transactions in the secondary market on the same loan. The key area with respect to RESPA is mortgage sales from primary market originators to purchasers. This is the area with the most regulation and greatest impact on the loan settlement process.

The growth of the secondary mortgage market since 1970 has been dramatic, especially for conventional single-family mortgages. In 1970, single-family sales were $13.6 billion; of that total, $10.8 billion or 79.8 percent were FHA/VA backed. By 1978, single-family sales had risen more than fourfold to over 60 percent of the market, with FHA/VA mortgages accounting for just under

TABLE VII

SECONDARY MORTGAGE MARKET ACTIVITY
ALL PROPERTY TYPES
(Millions of Dollars)

	1970	1971	1972	1973	1974	1975	1976	1977	1978
S&Ls									
Purchases	3,694	7,509	10,580	7,019	5,866	8,472	13,086	14,791	11,188
Sales	996	2,013	3,582	3,419	3,527	5,238	8,638	14,124	15,775
Net Purchases (Sales)	2,698	5,496	6,998	3,600	2,339	3,234	4,448	667	(4,587)
Commercial Banks									
Purchases	819	1,312	1,246	1,176	1,112	429	1,075	2,200	1,880
Sales	1,966	2,262	2,727	2,723	2,430	3,384	4,374	6,771	6,721
Net Purchases (Sales)	(1,147)	(950)	(1,481)	(1,547)	(1,318)	(2,955)	(3,299)	(4,571)	(4,841)
Mutual Savings Banks									
Purchases	1,809	2,433	3,222	2,517	1,521	1,781	2,580	3,409	3,268
Sales	283	270	341	266	376	267	548	284	350
Net Purchases (Sales)	1,526	2,163	2,881	2,251	1,145	1,514	2,032	3,125	2,918
Life Insurance Co.									
Purchases	800	636	606	780	669	510	407	812	1,549
Sales	120	65	19	17	33	128	9	84	52
Net Purchases (Sales)	680	571	587	763	636	482	398	728	1,497
Mortgage Bankers									
Purchases	60	415	1,482	1,396	899	808	2,235	3,259	3,286
Sales	11,896	15,777	17,831	16,654	16,164	16,323	18,867	24,243	30,870
Net Purchases (Sales)	(11,836)	(15,362)	(16,349)	(15,258)	(15,265)	(15,515)	(16,632)	(20,984)	(27,584)
Other Lender Groups									
Purchases	9,225	9,370	12,229	14,679	18,883	26,654	29,433	36,542	50,940
Sales	3,060	3,614	6,147	6,243	5,032	10,044	13,932	12,682	16,415
Net Purchases (Sales)	6,165	5,756	6,082	8,436	13,851	16,610	15,501	23,860	34,525
Total									
Purchases	16,406	21,673	29,305	27,567	28,949	38,664	48,816	63,013	72,111
Sales	18,320	24,001	30,647	29,322	27,562	35,294	46,368	58,188	70,183
Net Purchases (Sales)	(1,914)	(2,328)	(1,342)	(1,755)	1,387	3,370	2,448	(4,828)	1,928

Source: Department of Housing and Urban Development

() indicates sales exceed purchases

TABLE VIII

SECONDARY MORTGAGE MARKET ACTIVITY
1-4 FAMILY HOMES
(Millions of Dollars)

	1970	1971	1972	1973	1974	1975	1976	1977	1978
S&Ls									
Purchases	3,397	6,635	9,502	5,862	4,824	7,166	11,104	13,156	10,283
Sales	804	1,654	2,886	2,759	3,093	4,727	7,711	12,956	14,999
Net Purchases (Sales)	2,593	4,981	6,616	3,103	1,731	2,439	3,393	200	(4,716)
Commercial Banks									
Purchases	521	1,130	1,046	925	372	236	816	1,744	1,481
Sales	1,674	1,971	2,245	2,010	1,623	2,931	3,715	5,778	5,819
Net Purchases (Sales)	1,153	(841)	(1,199)	(1,085)	(1,251)	(2,695)	(2,899)	(4,034)	(4,338)
Mutual Savings Banks									
Purchases	1,408	1,874	2,708	1,958	1,039	1,132	2,128	2,947	2,802
Sales	254	175	202	161	228	233	457	221	290
Net Purchases (Sales)	1,154	1,699	2,506	1,797	811	899	1,671	2,726	2,512
Life Insurance Co.									
Purchases	198	185	207	247	187	125	114	194	803
Sales	19	37	5	8	24	25	3	5	20
Net Purchases (Sales)	179	148	202	239	163	100	111	189	783
Mortgage Bankers									
Purchases	60	403	1,431	1,382	880	784	2,216	3,210	3,189
Sales	9,000	12,394	14,315	13,907	14,886	14,450	17,080	22,150	28,413
Net Purchases (Sales)	8,940	(11,991)	(12,884)	(12,525)	(14,006)	(13,666)	(14,864)	(18,940)	(25,224)
Other Lender Groups									
Purchases	7,822	8,065	10,182	12,199	15,744	22,489	26,514	33,545	43,558
Sales	1,828	2,303	4,476	4,944	3,257	7,284	11,405	9,014	10,646
Net Purchases (Sales)	5,994	5,762	5,706	7,255	12,487	15,205	15,109	24,531	32,911
Total									
Purchases	13,408	18,292	25,076	22,573	23,046	31,931	42,892	54,795	62,114
Sales	13,579	18,534	24,129	23,789	23,111	29,649	40,371	50,123	60,186
Net Purchases (Sales)	173	(242)	947	(1,216)	(65)	2,282	2,521	4,672	1,928

Source: Department of Housing and Urban Development

() indicates sales exceed purchases

40 percent of the total. A big factor in this growth in conventional secondary market activity has been the effort of federal agencies to standardize conventional mortgages and provide a national market through which they can be traded.

With this standardization came many regulations and many forms lenders had to use to make their loans marketable. In addition to standardization, federal agencies have financed large amounts of mortgage originations in recent years. Since 1973, holdings of mortgages in mortgage pools and trusts and by federal agencies have increased by 160 percent--as compared with only a 72 percent increase in total mortgage holdings. The growth of mortgage pools and trusts associated with mortgage-backed securities has been even stronger--rising almost 400 percent from $18 billion in 1973 to over $85 billion in 1978. This growth has had a great impact on the secondary market and has resulted in increased liquidity in the mortgage lending sector.

Mortgage yields in the secondary market reflect the overall supply and demand for funds available for mortgage investment. In parts of the country where mortgage demand exceeds supply, mortgage rates tend to be above the national average. These higher rates set the base for yields in the secondary market, as lenders sell their loans to parts of the country where there is a surplus of funds characterized by lower than average mortgage rates. As a result, secondary market interest rates are generally 25 to 50 basis points higher, on average, than primary market rates; and in times of severe credit tightness, the spread may be even higher (see Table IVA).

APPENDIX C

PRIVATE MORTGAGE LENDING INSTITUTIONS

This appendix provides a summary of the mortgage lending process and a description of the five major private financial institutions active in residential mortgage lending. It is designed to provide an understanding of the various steps all mortgage lenders take in originating a mortgage loan, and it suggests ways in which the operations and behavior of these lenders might differ. The major types of lending institutions addressed are:

- savings and loan associations;
- commercial banks;
- mutual savings banks;
- life insurance companies; and
- mortgage banking companies.

These five types of lenders accounted for over 96 percent of single-family loan originations in 1978.

The description of each type of lender includes a discussion of their business operations, mortgage lending activity, non-mortgage assets, liability structure, secondary market activity, and profitability. Each type of institution differs significantly in the kind of loans originated and the availability of alternative investments. Following the descriptions of these five major groups of lenders is a discussion of a small group of other mortgage lenders and holders.

SAVINGS AND LOAN ASSOCIATIONS

The modern day savings and loan industry evolved from building and loan associations established in the first half of the 19th century. These institutions were formed to encourage thrift and foster the construction and purchase of homes. From this beginning, savings and loan associations (S&Ls) have grown to be the largest holders and originators of mortgage debt in the United States. At the end of 1978, S&Ls held $432.9 billion in mortgage loans, or 36.9 percent of the $1.17 trillion total, and accounted for 50.9 percent of all single-family residential non-farm mortgages. This origination share compares with 23.4 percent for commercial banks, 16.2 percent for mortgage bankers, 5.3 percent for mutual savings banks, and 1.5 percent for life insurance companies.

Mortgage Lending

At the end of 1978, mortgage loan holdings accounted for 82.7 percent of all S&L assets--a percentage that has remained fairly constant since 1950. S&Ls are limited by government regulations in the kinds of investments they can make, and they are given tax incentives to invest in mortgage loans (see Appendix 3, regarding tax treatment for S&Ls). These incentives include purchase of mortgages in the secondary mortgage market and mortgage passthrough securities. Because of these regulations, S&Ls are the largest holders and originators of mortgage loans.

According to HUD data, S&Ls made $101.6 billion in mortgage loans in 1978--more than double the $49.8 billion 1975 level. Mortgage originations for one-to-four unit homes accounted for $90.0 billion, or 88.5 percent of the total. Loans closed on all other properties accounted for 11.5 percent of S&L activity. S&L lending represented the financing of more than 2 million homes in 1978.

S&L industry activity has historically emphasized the one-to-four family home (see Exhibit C-1). At the end of 1978, $354.6 billion, or 81.9 percent of S&L mortgage loan holdings, were in one-to-four family homes. This represented 46.8 percent of all one-to-four family loans outstanding in the United States. By comparison, commercial banks--the second largest lending class had only 56.3 percent of their mortgage holdings in one-to-four family loans and accounted for only 16.7 percent of the total outstanding.

Multi-family mortgages comprised 8.4 percent of all S&L loan holdings at the end of 1978. In dollar terms, S&L multi-family holdings were greater than those of any other type of lender--accounting for 29.9 percent of the year-end 1978 total of $121.9 billion.

Historically, multi-family loans have increased as a percent of total loans outstanding at S&Ls; the rate rose from 1.5 percent in 1950, to 9.2 percent in 1970. In recent years, the percentage of multi-family loans within S&L portfolios has gradually declined--from 8.8 percent in 1976, to 8.4 percent in 1978. Conversely, the percentage of one-to-four family loans has gradually risen--from 80.4 percent in 1975, to 81.9 percent in 1978.

The sum of one-to-four family loans and multi-family loans accounted for 90.3 percent of all S&L mortgage holdings in 1978. This was up slightly from 90.0 percent in 1977, and 89.5 percent in 1975. Mortgages held in all other categories--including junior liens, real estate sold on contract and collateral loans secured by assignment of first mortgage loans--accounted for the remaining 9.7 percent of mortgages outstanding.

S&L mortgage lending has been primarily in conventional loans, with only a small amount of FHA-insured and VA-guaranteed lending. In 1978, 93.3 percent of mortgage loans held were conventional mortgages. This represented an increase in holdings of conventional loans--from 82.2 percent in 1970 and 89.0 percent in 1975. S&L mortgage originations in 1978 were almost exclusively in

EXHIBIT C-1

MORTGAGE LOAN HOLDINGS BY ALL SAVINGS AND LOAN ASSOCIATIONS
(Billions of Dollars End of Year Totals)

	1950	1960	1970	1975	1977	1978
TYPE OF PROPERTY						
Total Residential Mortgages	13.7	60.1	150.3	278.6	381.2	432.9
1 to 4 Family	13.1	55.3	124.5	223.9	310.7	354.6
Multifamily	.2	2.2	13.8	35.5	32.5	36.4
Other	.4	2.6	12.0	29.2	38.0	41.9
TYPE OF LOAN						
FHA/VA	–	10.7	18.7	30.6	30.2	29.2
Conventional	–	49.4	131.6	248.0	351.0	403.7
Mortgage-backed Securities	.6	2.4	7.0	24.0	33.9	40.3

conventional loans, which accounted for 97.6 percent of the total. Conventional loans accounted for 97.4 percent of 1978 single-family originations.

Non-Mortgage Assets

In addition to mortgage loans, S&L assets consist of other kinds of loans such as education, mobile home, home improvement, loans on savings accounts, and other consumer-type loans. In 1978, these loans amounted to $11.7 billion, or 2.2 percent of assets. S&Ls also held insured mortgages and mortgage-backed securities, FHLBB stock, real estate owned due to foreclosure, etc.--amounting to 15.1 percent of assets (see Exhibit C-2). S&Ls are not allowed to purchase corporate stock and are limited regarding the kind of securities in which they can invest for liquidity of asset purposes.

Liabilities

Because S&Ls were created to encourage thrift, savings accounts constitute the vast majority of S&L liabilities. Total savings deposits accounted for 82.3 percent of total S&L liabilities at the end of 1978. This was down from 84.2 percent in 1977, and 84.5 percent in 1975 (see Exhibit 2). Savings accounts are classified into two types: (1) savings earning the regular rate or less (passbook), and (2) savings earning more than the regular rate (certificate). As of December 31, 1978, only 31.9 percent of savings at FSLIC-insured S&Ls were held in passbook accounts--a dramatic reduction from 88.3 percent in 1966, and 37.9 percent in December 1977. This represents phenomenal growth in savings certificates, and it results from increased competition for savings among financial institutions and the increased sophistication of savers who are becoming more sensitive to the rate-of-return on investments.

In addition to savings, S&Ls can obtain funds by borrowing from the Federal Home Loan Bank System. These borrowings, called advances, accounted for 8.2 percent of liabilities at the end of 1978--up from 6.1 percent in 1977. S&Ls can also borrow funds from other financial intermediaries such as commercial banks; however, these borrowings accounted for only 2.1 percent of liabilities at the end of 1978. Loans in process accounted for 2.1 percent of 1978 liabilities--up from 1.5 percent in 1975--and represent the undisbursed portion of mortgage loans that have been recorded as assets.

S&L net worth at the end of 1978 totaled more than $29.0 billion, or 5.9 percent of liabilities. This was about the same as the 1977 level but down from the 6.2 percent 1975 level.

The structure of S&L and liabilities is such that S&Ls have the vast majority of their assets in long-term mortgages, while their liabilities are predominantly in short- to intermediate-term savings deposits. This makes S&Ls subject to interest rate risk because short-term liabilities respond much more quickly than long-term assets to interest rate fluctuations. As a result, S&Ls are becoming more sophisticated in their ability to manage funds and utilize all operating mechanisms available to them. Despite this growing sophistication, S&Ls are still highly restricted in the methods they can use to

EXHIBIT C-2

BALANCE SHEET FOR ALL SAVINGS AND LOAN ASSOCIATIONS
(Millions of Dollars End of Year Totals)

	1950	1960	1970	1975	1977	1978
ASSETS						
Mortgage Loans Outstanding	13,657	60,070	150,331	278,590	381,163	432,858
Cash and Investment Sec.	2,456	7,888	16,526	30,853	39,150	44,855
Real Estate Owned	21	158	746	1,662	1,787	1,630
FHLB Stock	177	978	1,539	2,600	3,200	4,000
Other Assets	582	2,382	7,041	24,528	33,941	40,306
Total Assets	16,893	71,476	176,183	338,233	459,241	523,649
LIABILITIES						
Savings Deposits	13,992	62,142	146,404	285,743	386,800	431,009
FHLB Advances	900	2,197	10,911	20,534	27,840	42,960
Loans in Process	403	1,186	3,078	5,128	9,911	10,737
Other Liabilities	318	968	3,389	6,949	9,506	9,918
Net Worth	1,280	4,983	12,401	19,779	25,184	29,025
Total Liabilities	16,893	71,476	176,183	338,233	459,241	523,649

p = Preliminary

attract funds and in the investments they can make. This makes them less competitive and prone to suffer from adverse operating experiences during periods of economic difficulty such as tight credit market conditions.

Secondary Market

Besides being originators of mortgages, S&Ls are also active in the secondary mortgage market. Insured S&Ls have historically been net purchasers (purchases exceed sales); however, this position changed for the first time in 1978. HUD data show that S&Ls purchased nearly $11.2 billion in mortgages and mortgage participations in 1978--down from the all-time high of $14.8 billion in 1977--and sold $15.8 billion. This means that in 1978 S&Ls were increasing their origination volume more than their holdings and were transferring mortgages to other holders. S&Ls are becoming increasingly active in selling mortgages in order to expand their mortgage origination volume. In 1978, S&L were the largest mortgage sellers of the institutions that hold mortgage debt, and the second largest sellers among mortgage originators--with sales only exceeded by mortgage bankers.

Profitability

S&Ls have historically operated with a very low rate of return on assets. In 1978, operating income amounted to 8.65 percent of average assets, while operating expenses were 1.33 percent. Interest on savings deposits and borrowed money amounted to 6.13 percent, resulting in a net income before taxes of 1.19 percent. Taxes amounted to 0.37 percent of average assets, leaving net income after taxes at 0.82 percent of average assets. This was up from 0.79 percent in 1977, and 0.64 percent in 1976, because of rising operating income which rose from 8.08 percent in 1976 to 8.65 percent in 1978.

Compared with other mortgage holding financial intermediaries, only mutual savings banks experienced a lower net income on assets than S&Ls in 1978. Because of this low rate of net income to average assets, any significant changes in S&L operating expenses will likely be passed on to borrowers in the form of higher mortgage interest rates and/or fees or points charged on mortgage loans.

COMMERCIAL BANKS

Commercial banks have been in existence since colonial times and are the largest group of financial intermediaries in the country. They have the broadest range of investment capabilities of any financial institution. Like other intermediaries, banks make their profits from the spread between the cost of attracting deposits and the income received from making loans and investments. In addition to being institutions that encourage thrift, banks hold demand deposits--the major component of the narrowly defined basic money supply (M1). Unlike other depository financial intermediaries, the majority of the commercial banking industry's business is not involved in residential mortgage lending--which accounted for only 10.6 percent of assets at the end of 1978. Because of their size--$1.2 trillion in assets--commercial banks, as compared

EXHIBIT C-3

MORTGAGE LOANS HELD BY COMMERCIAL BANKS
(Millions of Dollars End of Year Total)

	1950	1960	1970	1975	1977	19[illegible]
TYPE OF PROPERTY	13,663	28,806	72,755	136,186	178,979	213,9[illegible]
1 to 4 Family	9,481	19,242	42,329	77,018	105,115	126,964
Multifamily	950	1,120	3,311	5,915	9,215	10,91[illegible]
Commercial	2,264	6,796	23,284	46,882	56,898	67,0[illegible]
Farm	968	1,648	3,831	6,371	7,751	9,0[illegible]
TYPE OF LOAN						
FHA/VA	–	8,710	10,509	9,383	8,401	7,541
Conventional	–	20,096	66,246	126,803	170,572	206,4[illegible]

EXHIBIT C-4

BALANCE SHEET FOR COMMERCIAL BANKS
(Billions of Dollars End of Year Totals)

ASSETS	1950	1960	1970	1975	1977	1978
Credit Market Instruments	125.5	197.9	445.5	745.4	889.2	1009.6
US Government	64.5	63.9	76.4	119.9	139.5	138.8
Other Securities & Mort.	24.5	47.8	145.4	247.6	301.9	346.0
St & Loc Obligations	8.2	17.7	70.2	102.8	115.1	124.4
Corporate Bonds	2.6	1.3	2.4	8.6	7.9	7.7
Mortgages	13.7	28.8	72.8	136.2	179.0	214.0
Consumer Credit	7.4	20.6	53.9	90.2	118.7	167.2
Bank Loans NEC	28.1	62.9	161.6	277.3	314.7	344.5
Open Market Paper	.7	2.0	8.2	10.3	14.3	13.0
Security Credit	3.0	6.0	13.0	14.6	22.3	20.3
Other Interbank Claims	.2	.5	6.3	26.9	32.3	46.0
Member Bank Reserves	17.7	17.1	24.2	26.1	26.9	31.2
Miscellaneous Assets	6.9	14.5	37.3	82.5	117.4	118.6
Total Assets	150.3	230.0	513.3	880.9	1066.8	1225.7
LIABILITIES & EQUITY/RESERVES						
Demand Deposits	95.9	124.9	189.8	241.8	277.7	298.7
Time Deposits	37.0	73.6	233.1	455.6	550.7	619.4
Large Nego. CDs	0	1.1	28.1	82.9	77.4	100.0
Other	36.9	72.5	205.0	372.7	471.6	519.4
Corporate Bonds	0	0	2.1	4.5	5.7	5.9
Open Market Paper & Fed Funds	0	.3	4.0	17.1	26.4	36.7
Profit Taxes Payable	.5	1.5	1.0	.6	.6	.9
Interbank Liabilities	–	–	6.3	28.9	32.3	46.0
Miscellaneous Liabilities	6.4	11.6	45.7	85.3	114.7	152.8
Equity Capital, Surplus & Res.	10.5	18.1	31.3	47.1	57.7	65.3
Total Liabilities	150.3	230.0	513.3	880.9	1066.8	1225.7

with other lenders, are large residential non-farm mortgage lenders; they accounted for 23.4 percent of all 1978 single-family residential mortgage originations. Total mortgage lending by banks, including commercial and farm loans, amounted to 26.7 percent of all 1978 mortgage originations. This makes banks the second largest originator of mortgage debt (after S&Ls).

Mortgage Lending

Commercial banks held 18.2 percent of all mortgage debt outstanding at the end of 1978, as compared with 36.9 percent for S&Ls and 8.1 percent for mutual savings banks (see Table V in Appendix B). All mortgage holdings accounted for only 17.5 percent of total assets at commercial banks--up from 14.2 percent in 1970, and 9.1 percent in 1950. This increase was partly due to the rise in mortgage yields as compared with other investments, the development of the conventional secondary market, and the resurgence of conventional mortgage lending.

Single-family (one-to-four family) loans accounted for about 59 percent of year-end 1978 mortgage holdings--up from around 57 percent in 1975, and 58 percent in 1960 (see Exhibit 3). Multi-family lending has not been strong at commercial banks--accounting for only 5.1 percent of mortgage holdings at the end of 1978, up from 4.3 percent in 1975.

At the end of 1978 commercial banks had only 3.5 percent of their residential mortgage holdings in government-backed FHA/VA mortgages. The percentage of FHA/VA mortgages to residential holdings has declined over the years--accounting for 42.8 percent of holdings in 1960, 23.0 percent in 1970, and 11.3 percent in 1975. This sharp decline indicates that commercial bank mortgage originations in recent years have been predominantly in conventional loans. In 1978, less than 5 percent of single-family originations were in FHA/VA mortgages--down from 25 percent in 1970.

In addition to one-to-four family and multi-family loans, banks have significant holdings and originations in farm and commercial real estate loans. Commercial loans accounted for 31.3 percent of bank real estate loan holdings in 1978--down from 34.4 percent in 1975. Bank holdings of commercial loans accounted for 31.5 percent of all commercial mortgage debt outstanding at the end of 1978. Farm loans amounted to only $9 billion, or 4.2 percent of bank real estate loan holdings--down from 5.3 percent in 1960 and 7.1 percent in 1950. Bank farm loan holdings accounted for 11.9 percent of all farm mortgage debt outstanding in 1978.

Non-Mortgage Assets

With only about 17 percent of year-end 1978 bank assets invested in mortgage loans, the vast majority of bank holdings are in non-mortgage investments. Security holdings--including U.S. Government, state, and political subdivisions and corporate--accounted for 22.1 percent of total assets at the end of 1978 (see Exhibit 4). Consumer loans constituted 13.6 percent of assets, and other bank loans accounted for 28.1 percent. All other loan and security holdings d for 2.7 percent of assets; cash bank balance reserves, interbank and other assets represented 16 percent of total assets.

It is clear from looking at the distribution of other assets that commercial banks are much more diversified in their investment holdings than mutual savings banks and S&Ls. Because of this diversity, banks have substantial flexibility in selecting investments; however, they are obligated to provide certain services to customers e.g., checking accounts that tend to affect profitability by increasing costs.

Liabilities and Equity/Reserves

Liabilities at commercial banks fall into two general categories: deposits and borrowings. Deposits consist of: demand deposits (checking accounts), time deposits (savings held for specified time periods), and savings deposits (savings held for unspecified periods and withdrawable on request). Deposits accounted for 79.1 percent of liabilities at commercial banks as of December 31, 1978. Of the total of $918.1 billion in deposits, 32.5 percent were in demand deposits and 67.5 percent were in time and savings deposits, including 16.2 percent in large negotiable CDs.

Borrowings and other funds due consist of: federal funds, open market paper, corporate bonds, profit taxes payable, interbank borrowings, and miscellaneous liabilities. These accounted for only 20.9 percent of liabilities as of December 31, 1978. In addition to the above mentioned liabilities, commercial banks had equity capital, surplus, and reserves of $65.3 billion.

Secondary Market

Commercial banks have traditionally been net sellers (sales exceed purchases) in the secondary mortgage market. Mortgages sales by commercial banks accounted for about 10 percent of loan originations in 1978, according to HUD mortgage gross flows data. Of the estimated $6.7 billion in mortgage sales in 1978, about 87 percent were single-family mortgages. Commercial banks were the third largest seller of mortgages, after mortgage bankers and S&Ls.

Mortgage purchases by banks have traditionally been small and since 1970, when the HUD series began, have accounted for a smaller and smaller portion of commercial banks' secondary market activity. Purchases amounted to only $1.9 billion in 1978, providing banks with a net sales position of $4.8 billion. Approximately 79 percent of 1978 purchases were in single-family mortgages. FHA/VA mortgages accounted for about 25 percent of 1978 single-family sales and 18 percent of single-family purchases.

Profitability

The profitability of commercial banks, like that of other financial institutions, varies greatly from bank to bank. In 1978, operating income as a percent of average assets for FDIC-insured commercial banks was about 0.88 percent--compared with 0.82 percent for S&Ls and 0.58 percent for mutual savings banks. Earnings at commercial banks are significantly influenced by the rate of return on short-term asset holdings tied directly or indirectly to the market-sensitive prime rate. In years of high short-term rates, like 1977 and 1978, this has resulted in more rapid increases in bank earnings--as compared with S&Ls and mutual savings banks whose assets are of a much longer nature since they are dominated by long-term mortgages.

Historically, bank return on assets has generally been below that of S&Ls and mutual savings banks. On a yearly basis, however, banks can be more or less profitable than S&Ls or mutual savings banks, depending on short-term interest rates and yields on non-mortgage loans and securities.

MUTUAL SAVINGS BANKS

Mutual savings banks (MSBs) were first established in 1819. Their purpose was to: accept deposits (savings) and allow withdrawals of deposits; invest funds safely; use profits to cover expenses and add to reserves; and make dividend payments to depositors. Like S&Ls, MSBs are thrift institutions that encourage savings and act as financial intermediaries in making investments and extending loans to qualified borrowers.

MSBs have not grown as rapidly as S&Ls, commercial banks, or life insurance companies since the end of World War II. They are, however, the fourth largest provider of residential mortgage funds of the five financial institutions described in this chapter. In 1978, MSBs originated $12.7 billion, or 5.2 percent of the $243.9 billion in mortgages created in the United States. Single-family mortgage originations in 1978 amounted to $9.5 billion, or 5.3 percent of the total. Mortgage holdings constituted 60.2 percent of all MSB assets as of year-end 1978--down from 73.4 percent in 1970 because of increased investment in corporate, state, and local securities, and in non-mortgage loans.

Nature of the Business

As thrift-oriented financial intermediaries, MSBs encourage savings by offering interest bearing savings accounts through which individuals and institutions can invest their savings. With these savings deposits, MSBs make investments and loans in a fairly wide variety of areas--including mortgages, U.S. Government securities, state and local government securities, corporate securities, and other non-mortgage loan areas. MSBs are all private institutions, individually controlled by a local board of trustees who make the major decisions concerning operations. Unlike S&Ls, commercial banks, mortgage bankers, and life insurance companies, MSBS are located in only 17 states, and are concentrated in the Northeast. There were 465 MSBs at the end of 1978, with average assets of $340.2 million. Over 70 percent of these MSBs were located in Massachusetts, New York, and Connecticut. The number of MSBs in this country decreased from 637 in 1910, to 540 in 1940, and 494 in 1970. There are no stock MSBs; MSBs are therefore controlled by their members and their board of trustees, who have a purely fiduciary role. The state in which an MSB is domiciled provides its charter and regulates and supervises its activity. Allowable investments, services, and operating practices thus vary somewhat from state to state.

All MSBs are members of the Federal Deposit Insurance Corporation, and/or the Mutual Savings Central Fund, Inc. of Massachusetts. The FDIC and Central Fund insure savings accounts against loss, as FSLIC insures savings accounts at S&Ls. At the end of 1978, 325 MSBs were covered by FDIC insurance, while all 163 Massachusetts savings banks were insured by the Mutual Savings Central Fund, Inc., and 23 of them were insured by FDIC as well. About 18 percent of the MSBs are also members of the Federal Home Loan Bank System.

In addition to savings deposit insurance, mutual savings banks--like S&Ls and commercial banks--maintain a general reserve to protect against loss. In 1978, the general reserve amounted to 7.4 percent of savings deposits--as compared with 7.6 percent for commercial banks and 5.9 percent for FSLIC-insured S&Ls. These reserves, which include subordinated debentures, help to assure savers that their deposits will be secure from loss. The issuance of debentures is somewhat similar to stock S&Ls issuing additional capital stock.

Mortgage Lending

In 1978, MSBs held a total of $95.2 billion in mortgage loans (see Exhibit C-5). This accounted for 60.2 percent of MSB assets--compared with 59.8 percent in 1977--and was down from 63.8 percent in 1975, and 73.4 percent in 1970. Because most MSBs are located in the Northeast, the primary market demand for their supply of mortgage funds is weak relative to that of banks and S&Ls which both have a large number of institutions located in more growth-oriented states in the West and South. This has resulted in MSBs' having a lower percentage of their assets in mortgages than S&Ls have.

Another factor impacting mortgage lending is that unlike S&Ls, MSBs as well as commercial banks and life insurance companies, are not as restricted in the number of alternative investments available to them. This allows mutuals greater freedom to invest in the safest, highest yielding instruments available.

According to HUD, MSBs originated $12.7 billion in mortgage loans in 1978--a 78-percent increase from the 1975 level of $7.2 billion. Only 8.3 percent were in FHA/VA single-family loans; 66.4 percent were in conventional single-family mortgages; and the remaining 25.3 percent were in multi-family and non-residential mortgages.

Historically, MSB holdings of mortgages have had a relatively high percentage of multi-family loans as compared with S&Ls and commercial banks. In 1978, MSBs held $16.5 billion, or 17.4 percent of their mortgage portfolio, in multi-family loans--as compared with 9.3 percent for S&Ls and 7.9 percent for commercial banks. Only life insurance companies--at 56.8 percent--held a

EXHIBIT C-5

MORTGAGE LOANS HELD BY MUTUAL SAVINGS BANKS
(Millions of Dollars End of Year Total)

	1950	1960	1970	1975	1977	1978
TYPE OF PROPERTY						
Total Mortgages	8,262	26,935	57,948	77,249	88,104	95,157
1 to 4 Family	4,326	20,575	42,149	50,025	57,637	62,252
Multifamily	2,728	3,731	7,788	13,792	15,304	16,529
Non-Residential	1,208	2,629	8,011	13,432	15,163	16,376
TYPE OF LOAN						
FHA	1,615	7,074	16,087	14,427	14,187	14,203
VA	1,457	8,986	12,008	12,391	11,933	11,824
Conventional	3,962	8,246	21,842	38,999	46,821	52,754
GNMA, and Other Mortgage backed Securities	–	–	85	3,367	8,321	10,021

higher percentage. The 17.4 percent of holdings in multi-family mortgages is about the same as in the previous 3 years but is up from 13.4 percent in 1970. MSBs held 13.5 percent of all multi-family loans outstanding at the end of 1978.

Holdings of one-to-four family mortgages at MSBs amounted to $62.1 billion at the end of 1978, or 8.2 percent of the total outstanding. The growth rate in single-family holdings for MSBs from 1968 to 1978 was only 4.6 percent, as compared with 11.1 percent for all holders combined. This is indicative of the lack of growth in the demand for mortgages in the MSBs' general lending territory. To partially compensate for the weak local demand for mortgages in their own states, MSBs have gone out of state to purchase mortgages in the secondary market. In 1976 (the latest year available), out-of-state mortgage holdings amounted to 34.1 percent of total holdings, with 26.5 percent coming from non-savings bank states. By comparison, S&L loan purchases from 1960 to 1978 were only 12.2 percent of closings. While this is not strictly comparable to holdings, it does show how savings banks have had to purchase loans in a higher proportion to holdings than S&Ls, which originate mainly for their own portfolios.

Historically, MSBs have had a relatively high proportion of their mortgage holdings in federally underwritten mortgages (FHA-insured and VA-guaranteed). In 1978, 27.4 percent of MSB mortgage holdings were in FHA/VA loans--as compared with 8.5 percent for all mortgage lending financial institutions. In 1970, 48.5 percent of MSB holdings were in FHA/VA loans. This decline resulted from a resurgence in conventional mortgage lending precipitated in part by the Emergency Home Finance Act of 1970, which helped bolster the secondary market for conventional loans.

Non-Mortgage Assets

In addition to mortgages, MSBs as of year-end 1978 held about 6.3 percent of their assets in mortgage-backed securities such as GNMA passthroughs and, to some extent, FHLMC-mortgage participation certificates and other passthrough securities (see Exhibit C-6). MSBs also held 24 percent of their assets in government and corporate securities--down from 25.5 percent in 1975, but up from 20.4 percent in 1970. Non-mortgage loans accounted for 4.5 percent of lending, while cash and other assets amounted to 4.9 percent of total assets. Unlike S&Ls, which had only 17.3 percent of their 1978 assets in non-mortgage loans, savings banks had 39.8 percent. This was because the states that charter and regulate savings banks have defined more broadly the kinds of investments in which they can participate. This has resulted in a much more diversified portfolio and reduced overall risk from asset loss.

Liabilities and General Reserves

As with S&Ls, the majority of savings bank liabilities are in the form of short- and intermediate-term savings deposits. Deposits fall into three basic categories: (1) savings--ordinary or statement type savings accounts and interest-bearing now accounts (negotiable order of withdrawal, which is an savings account upon which the depositor may issue negotiable orders of withdrawal

EXHIBIT C-6

ASSETS AND LIABILITIES OF MUTUAL SAVINGS BANKS
(Millions of Dollars End of Year Total)

	1950	1960	1970	1975	1977	1978
ASSETS						
Mortgage Investments	8,039	26,702	57,860	80,588	96,526	105,178
Mortgages	8,037	26,702	57,775	77,221	88,195	95,157
GNMA MBS	–	–	85	3,367	8,331	10,021
Securities						
US Government	10,877	6,243	3,151	4,740	5,896	4,959
State and Local	96	672	197	1,545	2,828	3,333
Corporate and Other	2,260	5,076	12,791	24,626	29,587	29,711
Non-mortgage Loans	127	416	2,255	4,023	6,210	7,195
Cash and Other Assets	1,047	1,463	2,741	5,535	6,240	7,796
Total Assets	22,446	40,571	78,995	121,056	147,287	158,174
LIABILITIES AND RESERVES						
Deposits	20,025	36,343	71,580	109,873	134,017	142,701
Savings			59,345	69,653	78,005	71,816
Time			11,812	39,639	54,739	69,354
Other	132	257	423	582	1,272	1,531
Other Liabilities	137	678	1,690	2,755	3,292	4,565
General Reserve Accounts	2,283	3,550	5,726	8,428	9,978	10,907
TOTAL LIABILITIES & RESERVES	22,445	40,571	78,996	121,056	147,287	158,173

similar to checks); (2) time deposits--certificates, special notice accounts, and term and other time deposits; and (3) other--including school, club, checking, non-interest-bearing NOW accounts, and certain other accounts. In 1978, 96.9 percent or $142.7 billion in liabilities were in deposits. Of this 50.3 percent were in savings accounts, 48.6 percent in time accounts, and only 1.1 percent in other accounts.

As with certificates at S&Ls, time accounts at MSBs have undergone significant growth relative to savings. In 1970, only 16.5 percent of MSB deposits were in time accounts--as compared with 82.9 percent in savings accounts. As noted above, the ratio of savings to time accounts in 1978 was almost one-to-one. This has driven the cost of funds up from around 5 percent in 1970 to over 6 percent in 1978.

Other liabilities amounted to only 3.1 percent of total MSB liabilities and reserves in 1978, up from 2.3 percent in 1970. General reserve accounts, including capital notes and debentures, amounted to $10.9 billion in 1978.

Secondary Market

HUD data indicate that MSBs are net purchasers of mortgages in the secondary market. This is because they are located predominantly in the Northeast, where primary market loan demand is weak compared to supply. The HUD data show that in 1978 MSBs acquired $16.0 billion in mortgages, of which $3.3 billion were in purchases. It is likely that the HUD data underestimate purchases and overestimate originations--making secondary market purchases, especially from mortgage bankers, even larger.

In 1978, mutuals were the third largest mortgage purchaser of the five institutions described here. Their level of purchases exceeded that of life insurance companies and commercial banks and was about even with that of mortgage bankers. The volume of purchases compared to the total for all 11 lender groups in the HUD survey was small, accounting for only 4.7 percent of the total. MSB mortgage sales in 1978 amounted to only $350 million, or less then one-half of one percent of the total.

Mortgage purchases have historically been in single-family loans, accounting for 85.7 percent of their 1978 total. FHA/VA mortgages accounted for 45.1 percent of single-family purchases, about the same as the national average.

Profitability

MSBs pass on the majority of their earnings to depositors as interest, after deducting expenses and taxes and retaining a portion of income as reserves. In 1978, savings banks' retained earnings came to 0.58 percent--of total assets up from 0.55 percent in 1977, and 0.45 percent in 1976. This resulted from a continued rise in the rate of return on assets.

Given this low rate of retained earnings to average assets, it is likely that any increased expenses related to doing business will be passed on to borrowers. This would be particularly true of costs associated with originating mortgages. However, there is a great deal of variability in retained earnings from institution to institution; and therefore costs will not be passed along uniformly. Larger financial institutions are generally more cost efficient than small institutions. This applies to MSBs as well, so that MSBs with lower or negative rates of return will be less likely to absorb any increased costs.

LIFE INSURANCE COMPANIES

Life insurance companies, unlike savings and loan associations, mutual savings banks, and commercial banks, are not thrift or thrift-oriented institutions that hold savings and make investments with their deposit holdings. They are in the business of providing protection from potential future losses. To do this, they hold reserves to meet expected losses; the level of the reserves is determined on an actuarial basis (historical experience).

Life insurance companies first appeared in the United States in the 18th century and have grown to be the third largest class of financial institution (as determined by asset size), after commercial banks and savings and loan associations. According to HUD data, life insurance companies (LICs) in 1978 originated $14.9 billion in mortgage debt, or 6.1 percent of the U.S. total. This makes them the fourth largest lender, after S&Ls (41.7 percent), commercial banks (26.7 percent), and mortgage bankers (12.8 percent). LICs were the smallest of the five lenders in terms of single-family originations, with only $849 million in these loans made in 1978.

Nature of the Business

As noted above, LICs are in the business of issuing policies which will compensate the beneficiary of the policy in the event of a loss covered by the provisions of that policy. For this protection, the policy owner pays a premium which is the LIC's chief source of funds. With these premium payments, the LIC then purchases income-bearing investments such as mortgage loans, securities, real estate, etc. To protect the policy holder in the event of a loss, the LIC carries obligations--in the form of reserves--to meet calculated future losses. These reserve accounts represent a major portion of the liabilities of LICs. At the end of 1978, $2.9 trillion in life insurance was in force in the United States--up 143 percent from $1.2 trillion in 1968.

There were 1,825 LICs operating in the United States at the end of 1978, with average assets of $213.3 million. LICs are either stock or mutual with respect to ownership. At stock companies, the owners of the stock have a voice in company operations and benefit from the proceeds of the company through dividend payments on the stock held. Mutual companies are owned by the policy holders, who exercise some influence over the company's operations. Mutual policy holders benefit from the profits of the company through rebates or reductions in policy premiums. As of mid-1978, there were 1,680 stock life insurance companies and 141 mutual companies. The number of mutual companies has been declining since 1954, when there were 171. More stock companies are in operation now than at any time in the past. Since 1954, the number of stock companies has increased by 154 percent. Despite the small number of mutual companies, they tend to be older and larger and account for about 61 percent of the assets.

LICs are located in all 50 states and are regulated by the laws of each state, which are administered by state insurance departments. Each state has laws (regulations) for insurance companies domiciled within the state (company headquarters are located in the state) and for companies domiciled outside the state but doing business within the state. These laws cover the conduct of insurance business and investment policies. State regulatory commissions control the licensing of companies to sell insurance, the premium rate structure, and the level of required reserves. Some states require that LICs make loans or investments in that state in proportion to policy activity. LICs can do business in any state in which they are licensed--which gives them the broadest geographic business territory of any financial institution.

Mortgage Lending

At the end of 1978, LICs held $105.9 billion, or 9.0 percent of the mortgage loans outstanding in the United States (see Exhibit C-7). Mortgage loans accounted for 27.2 percent of assets. Of all financial intermediaries, only commercial banks, at 16.4 percent, held a smaller percentage of assets in mortgage loans. However, in dollar terms, bank holdings of mortgages were more than twice those of LICs. The percentage of mortgages to total assets at LICs has been declining since 1966, when they accounted for 38.6 percent of assets. This decline resulted in part from a narrowing yield spread between mortgages and other investment alternatives, such as securities, and from the ease with which securities could be purchased as compared with mortgages.

LIC holdings of mortgages are dominated by commercial loans, which accounted for 58.6 percent of their mortgage holdings at the end of 1978. Multifamily residential mortgages made up the second largest category of mortgage holdings, at 18.0 percent--followed by one-to-four family residential mortgages at 13.6 percent, and farm mortgages at 9.8 percent. Because of this distribution, single-family residential mortgage holdings by LICs were only 1.9 percent of all single-family residential holdings in the United States. The volume of all types of mortgage loans held by LICs rose more slowly from 1975 to 1978 than any of the other four major types of financial institutions--increasing a total of 18.8 percent, as compared with 45.9 percent for all financial institutions. Total LIC assets for the same period increased by 34.5 percent, as holdings in other assets rose by 41.4 percent. Since 1975, LIC holdings of residential mortgages have actually declined by 10.1 percent--as compared with an increase of 66.3 percent for all major financial institutions. This indicates a continued trend of LICs away from mortgage investments and towards government, foreign, and business securities.

According to HUD, LICs originated an estimated $14.9 billion in mortgages in 1978. Of this, 5.7 percent, or $849 million were in single-family residential loans--with 64.2 percent in non-residential loans and 18.0 percent in

EXHIBIT C-7

MORTGAGE LOANS HELD BY LIFE INSURANCE COMPANIES
(Millions of Dollars End of Year Totals)

	1950	1960	1970	1975	1977	1978
TYPE OF PROPERTY						
Mortgages Total	16,102	41,771	74,375	89,168	96,765	105,932
1 to 4 Family	8,478	24,879	26,762	17,590	14,727	14,449
Multifamily	2,615	3,865	15,999	19,629	18,807	19,026
Commercial	3,682	10,045	25,965	45,196	54,388	62,086
Farm	1,327	2,982	5,649	6,753	8,843	10,371
TYPE OF LOAN						
FHA/VA	6,599	15,933	16,813	11,823	9,939	9,284
Conventional	9,503	25,838	57,562	77,345	86,826	96,648

farm loans. FHA/VA mortgages accounted for 14.2 percent of all LIC residential originations.

At the end of 1978, holdings of FHA and VA mortgages amounted to $9.3 billion, or 8.8 percent in mortgages holdings--compared with 8.5 percent for all financial institutions. Only commercial banks held a smaller dollar volume of federally underwritten mortgages, at $7.5 billion. The dollar volume of FHA/VA mortgage holdings for LICs has dropped each year since 1966, when they amounted to $18.6 billion.

Non-Mortgage Assets

Non-mortgage assets accounted for 72.8 percent of total LIC assets at the end of 1978--up from 69.2 percent in 1975, and 64.1 percent in 1970. The composition of these assets and their levels have fluctuated over time because of yield differentials between the various investment alternatives (see Exhibit C-8).

As noted above, LICs have a significant amount of flexibility in the kinds of investments they can make. At the end of 1978, 55.8 percent of their assets were in government and business securities; of this, 91.0 percent were in business securities, especially corporate bonds. Other asset holdings include direct ownership of real estate (concentrated in multi-family and office building income-earning properties) at 3.0 percent of assets, loans to policy holders at 7.8 percent, and all other types of assets (including due and deferred premiums, cash holdings, due and accrued investment income, etc.) at 6.2 percent.

Obligations

LIC liabilities (obligations) consist primarily of policy reserves. At the end of 1978, these reserves accounted for 81.9 percent of obligations--up from 80.8 percent in 1970. State laws require that these policy reserves be kept at a level that will ensure payment of all policy obligations as they fall due. Other obligations include policy dividend accumulations--2.9 percent; funds set aside for the following year's policy dividends--1.6 percent; and other obligations, including pension plans--7.1 percent. In addition, LICs hold surplus funds to provide for contingencies and unassigned surpluses held as protection for policy obligations amounting to 6.2 percent. The par value of LICs' capital stock amounted to $1.96 billion at year-end 1978.

The financial risk to LICs is not as strongly tied to the changes in investment yields as are the risks to thrift institutions that must contend with disintermediation in periods of high or rising interest rates. LICs must protect themselves against anticipated policy obligations; however, these are much more predictable than thrift liabilities. Because of this greater certainty, LICs operate in a more stable environment than thrift institutions.

Secondary Market

According to HUD data, LICs are not active participants in the secondary mortgage market. It should be noted that the HUD data underestimate purchases

EXHIBIT C-8

BALANCE SHEET FOR LIFE INSURANCE COMPANIES
(Millions of Dollars End of Year Total)

ASSETS	1950	1960	1970	1975	1977	1978
Securities	41,469	63,536	99,576	269,075	195,207	216,921
Government	16,118	11,815	11,068	13,758	19,553	19,579
US	13,459	6,528	4,574	4,738	5,315	4,795
State & Local	1,152	3,588	3,306	4,508	6,051	6,250
Foreign	1,507	1,699	3,188	4,514	8,187	8,534
Business	25,351	51,721	88,518	135,317	175,654	197,342
Bonds	23,248	46,740	73,098	107,256	141,891	161,923
Stocks	2,103	4,981	15,420	28,061	33,763	35,419
Mortgages	16,102	41,771	74,375	89,167	96,848	105,932
Real Estate	1,445	3,765	6,320	9,621	11,060	11,776
Policy Loans	2,413	5,231	16,064	24,467	27,556	30,202
Other Assets	2,591	5,273	10,909	16,971	21,051	24,190
Total Assets	63,020	119,576	207,254	289,304	351,722	389,021
Obligations and Surplus Funds						
Policy Reserves	54,946	98,473	167,556	235,057	289,932	318,483
Policy Dividend Accum.	N.A.	3,381	6,068	8,814	10,427	11,319
Funds for Policy Div.	N.A.	1,780	3,540	4,875	5,839	6,380
Other Obligations	N.A.	6,268	12,767	19,995	23,907	27,495
Special Surplus Funds	N.A.	1,989	3,283	2,972	21,669*	24,285*
Unassigned Surplus	N.A.	6,838	12,368	15,663	21,669*	24,285*
Capital (Stock Companies)	N.A.	847	1,672	1,928	1,948	1,962
Total Obl. & Surplus Funds	63,020	119,576	207,254	289,304	351,722	389,021

*All surplus funds = special + unassigned surplus.

and overestimate originations--especially as they pertain to activities connected with mortgage bankers--because of differences in the definition of what constitutes a mortgage origination.

The HUD data show that LICs have historically been net purchasers in the secondary market. In 1978, they purchased $15 billion in mortgages and sold only $52 million. The secondary market is used by LICs to acquire single-family mortgages. In 1978, single-family loans accounted for almost 52 percent of purchase. This was followed by non-residential mortgages at 44 percent, and multi-family mortgages at 4 percent. Of the single-family mortgages purchased in 1978, 80.4 percent were in conventional mortgages--well above the average of 54.2 percent for the 11 HUD lending groups.

Profitability

Because of the difference in operation and insufficient data pertaining to LICs' operating expenses, it is not possible to calculate a net income to average assets figure that would be comparable to that for other financial institutions.

MORTGAGE BANKING COMPANIES

Mortgage banking activity in the United States dates back to the period after the Civil War, when developing agricultural areas in the Midwest needed additional financing and investors in the East were seeking profitable investments. Because of the travel distance and time involved in communication, as well as the parochial character of real estate transactions, the investors from the East needed to have local representatives on the scene to handle the transactions and represent their interests. As the country became more urban, mortgage banking activity developed in the cities.

The mortgage banking industry has grown from this beginning to the point where in 1978 they were the third largest group of mortgage loan originators in the United States. According to HUD data, mortgage bankers originated $31.3 billion in mortgages in 1978, or 12.8 percent of the total; of this, $28.6 billion were in single-family mortgages.

Nature of the Business

The mortgage banking function is that of an intermediary bringing together real estate purchasers' demands for mortgage financing with investors' supplies of funds available for acquisition of mortgages. As an intermediary, the mortgage banker satisfies the needs of both the borrower and the lender.

Mortgage banking firms perform more functions than do most mortgage lending institutions that retain closed loans in their own portfolios. Portfolio lenders do not traditionally warehouse or market residential loans in the secondary market. Not only do mortgage bankers warehouse and market loans in the secondary market, but they may also be required to follow stricter origination and servicing standards than portfolio lenders. For loan originations, these requirements may include specifications about the mortgage (sales price, mortgage amount, loan-to-value ratio), property characteristics (age, style, location), and documentation required (appraisal, survey, title insurance, income verification). Loan servicing requirements may include specifications for reports, collection efforts, and management of the foreclosure process.

Most of the mortgage companies of any significant size and activity are members of the Mortgage Bankers Association of America, which consisted of 734 member mortgage banking firms at the end of 1977. The distribution of firms by size is very skewed, with a substantial number of small firms but few large firms. More than half the firms (415) had less than $1 million in servicing income and accounted for only 8 percent of total industry servicing. At the other end of the size distribution, only 45 firms had above $800 million in servicing but accounted for 50 percent of the industry total. The greatest amount of mortgage banking activity and the largest numbers of mortgage banking firms are found in California, Texas, and Florida.

For every $1 of equity, the typical mortgage banking firm in 1977 borrowed about $8 from others and serviced about $130 of mortgage loans for others. The mortgage banking industry is highly competitive, and mortgage companies are often forced to accept short-term losses in order to meet the interest rates quoted by their competitors.

Mortgage Lending[1]

The recent history of mortgage banking shows a strong growth pattern with cyclical interruptions. From 1962 to 1978, the volume of mortgage loans originated by the industry increased sixfold. Before the mid-1960s a significant proportion of origination activity was in single-family conventional loans. After the life insurance investors largely withdrew from acquisition of conventional single-family mortgages by 1967, origination of these loans dropped to a mere $0.4 billion--only 3.1 percent of the total of $13.0 billion, in 1970 (see Exhibit C-9).[1] In contrast, the volume of conventional single-family

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[1] This description of the mortgage banking industry is based on data developed by the Mortgage Bankers Association (MBA). The MBA data, especially data on mortgage originations and secondary market activity (sales), differ from those developed by HUD. Differences in the data are due to the use of different definitions of the mortgage origination process and sampling process. At present, HUD is revising its mortgage gross flows data to make them more compatible with MBA data; however, these data are not available at this time. As the revised data become available, they will be incorporated into this study. These revisions will affect mortgage data for other mortgage lenders in addition to mortgage bankers.

EXHIBIT C-9

MORTGAGE BANKING INDUSTRY LOAN ORIGINATIONS FIRST MORTGAGE LOANS

	Single-Family						
Year	Conventional	FHA	VA	Total	Multifamily	Nonresidential	Total
			(Dollars in Billions)				
1962							7.0
1963							8.7
1964							9.5
1965							10.9
1966				6.5			9.3
1967				6.7			9.7
1968	0.7	4.0	2.5	7.2	1.2	1.8	10.4
1969	0.5	4.7	2.7	7.8	1.7	2.1	11.6
1970	0.4	5.5	2.6	8.6	2.1	2.4	13.0
1971	0.6	7.2	4.1	11.9	2.9	3.2	18.0
1972	2.2	6.1	4.9	13.3	3.5	4.3	21.7
1973	4.1	3.6	5.0	12.7	3.3	5.0	21.0
1974	3.5	3.7	6.1	13.2	2.5	4.4	20.1
1975	3.3	5.0	6.8	15.1	1.6	3.6	20.3
1976	4.0	5.9	9.1	19.0	1.4	3.1	23.6
1977	5.8	8.2	11.6	25.5	2.0	5.1	32.6
1978*	11.6	12.6	12.1	36.5	1.5	6.2	44.2

*Preliminary

Source: Mortgage Bankers Association

originations exceeded $1 billion a year in the early 1960s and represented over 15 percent of the industry's total volume at that time.[1]

In the early 1970s, conventional single-family lending surged, initially in response to new outlets for these loans: the savings and loan industry and the Federal National Mortgage Association. From 1976 to 1978, conventional single-family loan origination volume soared from $4 billion to $11.6 billion and accounted for 26.2 percent of total origination volume in 1978. Furthermore, the overall share of single-family loan origination volume reached 82.6 percent of the industry total in 1978--up from a cyclical low of 60.5 percent in 1973, and well above the 69.9 percent in 1966.

At the end of 1978, the mortgage banking industry was servicing $185 billion of first mortgage loans of all types--accounting for 15.8 percent of the $1,170 billion of total mortgage debt outstanding in the nation. Of the total industry servicing, $146 billion, or 80 percent, was in home mortgages--with about three--fourths in FHA/VA mortgages and one-fourth in conventional mortgages. However, the conventional single-family loan share has increased steadily in recent years.

During 1978, the mortgage banking industry originated $36.2 billion of single-family residential loans, which represented about 20 percent of total residential loans originated by the major lender groups. Most of the home mortgage loans originated by mortgage companies are insured by FHA or guaranteed by VA. In 1978, mortgage banking FHA/VA origination volume was $24.6 billion, or 68 percent of total industry activity. In recent years, the mortgage banking industry has accounted for two-thirds to three-fourths of all FHA/VA lending in the nation. Conventional home mortgages represent a rapidly growing proportion of mortgage company originations, amounting to $11.6 billion or 32 percent of the industry total in 1978--up from $5.8 billion and 3 percent in 1977.

Assets

Turning now to the balance sheet of the mortgage banking industry (Exhibit C-10) about half the assets consist of first mortgages in inventory--mostly in the form of loans being warehoused between the time of loan closing and final delivery to investors. Another one-fifth of the assets consist of construction

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[1] No specific information is available on the volume of conventional single-family mortgages originated by the mortgage banking industry before 1968; however, the volume of these loans in the servicing portfolio was $6.8 billion in 1962, and represented 11.4 percent of total loans serviced by mortgage bankers. This is clear evidence of the high volume of earlier activity in originating conventional single-family loans, and it is far above the tiny 3.1 percent share of total origination volume accounted for by these loans in 1970.

EXHIBIT C-10

BALANCE SHEET
AVERAGE MORTGAGE BANKING FIRM, DECEMBER 31, 1977

Assets	Percent of Total
Inventory	
First Mortgage (at cost)	
1 to 4-Family*	44.9
Other*	3.6
Construction Loans	20.2
Other Loans	9.6
Cash and Other Current Assets	9.3
Noncurrent Assets	12.4
	100.0

Liabilities	
Commercial Paper	42.5
Notes Payable to Banks	34.7
Other Current Liabilities	7.4
Noncurrent Liabilities	4.8
Stockholders' Equity	10.6
	100.0

Source: Mortgage Bankers Association of America, Financial Statements and Operating Ratios, 1977.

* Note: Division of first mortgages in inventory estimated to be 92.9 percent 1 to 4 family and 7.1 percent other first mortgages.

loans, and another one-tenth are other loans in inventory. Of the remaining assets, about 5 percent are in liquidity and about 15 percent are in non-current assets.

Liabilities

On the liability side of the balance sheet, stockholder equity accounts for about 10 percent, non-current liabilities for about 5 percent, and the remainder is in the form of borrowings--mostly short-term to finance the loans in warehousing inventory. Mortgages held in warehousing totaled $9.7 billion at the end of 1977, or about 5.2 percent of total loan servicing.

Secondary Market

Virtually all of the loans originated by mortgage companies are resold to investors in the secondary mortgage market. The life insurance industry used to be the largest single investor. Since the late 1960s, however, other groups have had greater activity, including the Federal National Mortgage Association, the savings and loan industry, and the GNMA-guaranteed mortgage-backed securities. Other important investors over the years have included the mutual savings bank industry, various government agencies, and the commercial banks, either for their own portfolios or for trust funds they administer. (See Exhibits C-11 and C-12 for secondary market activity.)

Profitability

Profit margins in the industry are very small. For the average firm in 1977, net income after taxes amounted to only 0.42 percent of the total origination volume of all types of loans. As a proportion of total servicing volume, net income was only 0.09 percent for the average firm.

Industry profitability has been very cyclical. In part, this is a consequence of the risk inherent in the commitment process during periods of volatile and rising interest rates. Other factors include changes in volume of activity and great variations in results from construction and land development lending. During the real estate depression in 1974 and 1975, the industry as a whole lost money. Even though the industry had exceptionally good profit performance in the early 1970s, this did not fully compensate for the substantial losses and low earnings in the mid-1970s. A number of firms were merged or forced into bankruptcy as a result of losses in the mid-1970s.

Industry profitability has also demonstrated wide variation among firms within the industry. In typical years, high-profit firms with earnings above the industry median posted after-tax return on equity more than twice as high as the overall median for the industry. Thus, it is very difficult to generalize about individual firms from industry averages.

EXHIBIT C-11

SHARE OF SALES FROM PRIMARY MARKET TO SECONDARY MARKET
(Billions of Dollars)

Year	Total Sales [1]	Mortgage Banking Sales		S&L Sales		Others[2]	
	$	$	%	$	%	$	%
1978	N.A.	44.2	N.A.	15.8	N.A.	N.A.	
1977	N.A.	32.6	N.A.	14.1	N.A.	N.A.	
1976	37.5	23.6	63	8.6	23	5.3	14
1975	29.7	20.3	68	5.2	17	4.2	15
1974	26.5	20.1	76	3.5	13	2.9	11
1973	27.7	21.0	76	3.4	12	3.3	12
1972	28.6	21.2	24	3.6	13	3.8	13
1971	23.0	18.0	78	2.0	9	3.0	13
1970	16.6	13.0	78	1.0	6	2.6	16

[1] Total sales represent mortgage sales by all private lenders from HUD gross mortgage flow except for mortgage bankers whose data comes from the Mortgage Bankers Association.

[2] Private mortgage lenders.

Source: MBA, Mortgage Banker Magazine (Kidd article), and HUD Gross Mortgage Flows.

EXHIBIT C-12

MORTGAGE BANKING SALES BY TYPE OF INVESTOR PURCHASING LOANS
1977
(Billions of Dollars)

	1-4 Family Residential				Multifamily	Non-Residential	Total	
	FHA	VA	Conventional	Total			$	%
GNMA Mortgage Pools	5.2	7.7	–	12.9	.4	–	13.3	40.8
Life Insurance Companies	.1	.1	.1	.4	.7	3.8	4.9	15.0
FNMA	1.0	1.2	2.1	4.3	*	–	4.3	13.2
Savings & Loan Association	.4	.7	1.6	2.7	.1	.4	3.2	9.8
Commercial Banks	.2	.3	.7	1.2	.2	.5	1.9	5.8
Mutual Savings Banks	.3	.5	.4	1.2	.2	.1	1.6	4.9
Others	1.0	1.1	.9	2.8	.4	.3	3.4	10.4
Total	$8.2	$11.6	$5.8	$25.5	$2.0	$5.1	$32.6	100.0

*Less than $0.5 billion.

Note: Total may not add due to rounding.
Source: Mortgage Bankers Association

OTHER MORTGAGE LENDERS AND HOLDERS

The five major financial institutions described above accounted for 92.5 percent of all mortgage originations in 1978. Their mortgage holdings excluding mortgage bankers, represented 72.3 percent of all mortgage holdings. Holdings by mortgage bankers are discussed below. The remaining 27.7 percent of mortgage holdings are divided among three basic groups: federal and related agencies; mortgage pools or trusts; and individuals and others.

Federal and related agencies as a group held $81.9 billion in mortgages, or 7 percent of the 1978 total. The largest holder in this group was FNMA--with $43.3 billion in mortgages, $37.6 billion of which were in one-to-four family loans. Federal Land Banks held $25.6 billion in mortgages, of which $24.7 billion were in farm loans. The remaining $12.9 billion was divided among GNMA, the Farmer Home Administration, FHA, VA, and the Federal Home Loan Mortgage Corporation (FHLMC). In 1978, mortgage originations for this group totaled $14.4 billion, or 5.9 percent of the total, of which $4.8 billion were in one-to-four family loans.

As a group, federal and related agency holdings of mortgages have increased by only 22.4 percent since 1975--less than half the U.S. increase. This slow growth is due to the fact that GNMA, the Farmers Home Administration, and FHLMC pool mortgages to back passthrough and other mortgage-related securities.

The second group, mortgage pools and trusts, represents the outstanding principal balances of mortgages backing securities insured or guaranteed by a federal or federal-related agency. This group is not involved in mortgage originations but accounted for $88.6 billion, or 7.6 percent of all mortgage holdings in 1978. Agencies included here are: GNMA, which accounted for 61.3 percent of the loans in this group; Farmers Home Administration, with 25.3 percent; and FHLMC, with 13.4 percent. This group's mortgage holdings are the fastest growing of any class of holder. From 1975 to 1978, mortgages held to insure or back a security rose from $34.1 billion to $88.6 billion--an increase of 160 percent or more than three times the increase in overall holdings. Within this group, the greatest increase has been experienced by FHLMC, whose holdings grew by 640 percent from 1975 to 1978.

The third group of holders consists of individuals and others. This group includes mortgage banking companies (warehoused loans), real estate investment trusts, state and local credit agencies, state and local retirement funds, credit unions, non-insured pension funds, and other U.S. agencies. In 1978, this group accounted for $154.1 billion, or 13.1 percent of all mortgage holdings. This represents an increase in holdings of 29.2 percent since 1975, or about 88 percent of the total percentage increase in mortgage holdings for the United States. One-to-four family mortgages accounted for 53.6 percent of 1978 holdings for this group, as compared with 65 percent for the United States, and was up from 47.2 percent in 1975.

Credit unions are the only institutions in this group with the potential for substantial growth in mortgage lending. They have never been active in the mortgage market because until 1978 they were restricted to loans with a maximum maturity of 10 years. However, The Financial Institutions Regulatory and Interest Rate Control Act of 1978 extended this maximum term to 30 years. Several very large credit unions have announced their intention to become active in the mortgage market. However, most of the credit unions are small. Their ability to make mortgage loans appears to be limited in the near future.

SUMMARY

This appendix presents information on the major mortgage originating institutions in the United States. Members of each group will be surveyed for the final RESPA Analysis study. Data from HUD-1 analysis and survey results will yield insights regarding the similarities and differences between the groups.

As this appendix shows, these institutions differ in many respects: loan type, customer type, financial structure, and profitability. Thus mortgage lenders are a heterogeneous group, with each participant playing a slightly different role and meeting demands from slightly different customer types. However, each segment is a necessary component of the whole industry.

APPENDIX D

FEDERAL REGULATORY STATUTES

The regulatory environment of the residential mortgage lending industry encompasses a myriad of state and federal pronouncements that significantly impact residential real estate settlement costs. That impact, which is potentially a function of compliance costs incurred by the lender, makes examining the regulatory environment--and, more specifically, the compliance responsibilities--an essential component of an assessment of the Real Estate Settlement and Procedures Act (RESPA). To facilitate discussion of the compliance responsibilities, selected pronouncements are distinguished by source (state or federal) and by form (statutory or regulatory).

The federal statutory component of the regulatory environment is reflected in such statutes as the:

- National Flood Insurance Act of 1968;
- Flood Disaster Protection Act of 1973;
- Fair Credit Reporting Act of 1970;
- Truth in Lending Act;
- Equal Credit Opportunity Act;
- Home Mortgage Disclosure Act of 1975;
- Fair Housing Act (Title VIII of the Civil Rights Act of 1968);
- Community Reinvestment Act of 1977;
- Fair Debt Collection Practices Act; and
- Real Estate Settlement Procedures Act.

The extent of their impact may be discerned in part from Exhibit D-1, which reflects preparations required for a conventional single-family mortgage with no insurance and no guarantees, and for the lender's own portfolio. The following examination of these statutes will permit a better understanding of the extent of compliance responsibilities.

NATIONAL FLOOD INSURANCE ACT OF 1968 AND THE FLOOD DISASTER PROTECTION ACT OF 1973

The National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, which are the statutory underpinnings of the National Flood

EXHIBIT D-1

PREPARATIONS REQUIRED FOR CONVENTIONAL SINGLE-FAMILY MORTGAGES WITHOUT INSURANCE OR GUARANTEES

	REPORT	PAGES	LINES OR ITEMS	COPIES	MANDATED BY LAW	INFLUENCED BY LAW
1.	Notice to Applicants	1	27	3	X	
2.	Underwriting Standards	8	320	3	X	
3.	Loan Application	2	216	2		X
4.	Insurance Information	1	3	1		
5.	Good Faith Estimate of Closing Costs	1	27	3	X	
6.	Buyer's Disclosure of Real Party in Interest	1	9	3	X	
7.	RESPA Docket	1	28	3	X	
8.	Notice of Right of Recission	1	32	3	X	
9.	Credit Report	1	54	3		X
10.	Appraisal Form	1	398	2		X
11.	Information on Lawyers	1	46	2		
12.	Loan Disbursement Record	1	80	2		
13.	Regulation Z, Truth in Lending	1	58	3	X	
14.	HUD Settlement Statement	1	24	3	X	
15.	Loan Check Requisition	1	14	2		
16.	Note	1	41	3		
17.	Mortgage	4	118	3		
18.	HUD Guide for Home Buyers	31	1,953	2	X	

Source: Savings & Loan News, November 1978, p. 100

Insurance Program, were enacted to reduce annual flood losses. They require that a lender determine whether: (a) a residential unit on which a loan is to be made is located in an area HUD has designated as having a special flood hazard; and (b) the community is participating in the National Flood Insurance Program.

If the subject residence is located in a special flood hazard area and the community is participating in the program, the lender must give the borrower written notice that the residence is in a hazard area or obtain written assurance from the seller or landlord that the borrower has been informed of the fact at least 10 days prior to the closing of the loan. The lender must also specify what minimum amounts of flood insurance are acceptable, where such insurance can be obtained, and what proof of insurance will be required at settlement.

If the subject residence is located in a special flood hazard area and the community is a non-participant in the National Flood Insurance Program, lenders are precluded from making federally insured or guaranteed mortgages and are obliged to notify borrowers--before making a loan--that disaster relief will not be available, in the event of the flood, until such time as the community becomes a participant in the program.

These two Acts affect residential real estate settlement costs because compliance costs are most frequently recouped in loan origination fees borne by the purchaser/borrower at closing.

FAIR CREDIT REPORTING ACT OF 1970

The Fair Credit Reporting Act of 1970 was enacted to ensure that consumer credit reporting agencies adopt reasonable practices and procedures in providing consumer credit information. It applies to lenders as users of credit reports, as set forth in subsections (a) and (b) of Section 615 of the Act which requires that:

> (a) whenever credit or insurance for personal, family, or household purposes, or employment involving a consumer is denied or the charge for such credit or insurance is increased either wholly or partly because of information contained in a consumer report from a consumer reporting agency, the user of the consumer report should so advise the consumer against whom such adverse action has been taken and supply the name and address of the consumer reporting agency making the report...
>
> (b) whenever credit for personal, family, or household purposes involving a consumer is denied or the charge for such credit is increased either wholly or partly because of information obtained from a person other than a consumer reporting agency bearing upon the consumer's credit worthiness, credit standing,

> credit capacity, character, general reputation, personal characteristics, or mode of living, the user of such information shall, within a reasonable period of time, upon the consumer's written request for the reasons for such adverse action received within sixty days after learning of such adverse action, disclose the nature of the information to the consumer. The user of such information shall clearly and accurately disclose to the consumer his right to make such written request at the time such adverse action is communicated to the consumer...

The applicable provisions saddle the lender with disclosure responsibilities regarding information both received from credit reporting agencies and obtained from other sources. The Act's requirements affect the lender in three ways because the lender must initially bear the responsibilities and costs of: disclosure, record retention, and compliance education. The costs are then frequently passed along to the borrower with a resultant increase in settlement costs and/or interest.

It should be pointed out that in the context of real estate transactions, circumstances triggering the disclosure requirements under the Fair Credit Reporting Act necessitate disclosure under the Equal Credit Opportunity Act as well. However, the disclosures required under the two acts in such circumstances may be incorporated into a single disclosure document.

TRUTH IN LENDING ACT

The Truth in Lending Act, which was enacted as part of the omnibus Consumer Credit Protection Act of 1968 and implemented by Regulation Z, seeks to establish uniform disclosure rules for consumer credit transactions. The Act and accompanying Regulation Z essentially require that a lender disclose:

(1) The date on which the finance charge begins to accrue as an obligation of the borrower if different from the date of the transaction.

(2) The finance charge expressed as an annual percentage rate, using the term annual percentage rate, except in the case of a finance charge not exceeding specific amounts.

(3) The number, amount, and due dates or periods of payments schedules to repay the indebtedness and, except in the case of a loan secured by a first lien or equivalent security interest on a dwelling made to finance the purchase of that dwelling and except in the case of a sale of a dwelling, the sum of such payments using the term "total payments." If any payment is more than twice the amount of an otherwise regularly scheduled equal payment, the creditor must identify the amount of such payment by the term "balloon payment" and

state conditions, if any, under which that payment may be refinanced if not paid when due.

(4) The amount, or method of computing the amount of any default, delinquency, or similar charges payable in the event of late payments.

(5) A description or identification of any type of security interest held or to be retained or acquired by the creditor in connection with the extension of credit, and a clear identification of the property to which the security interest relates, or, if such property is not identifiable, an explanation of the manner in which the creditor retains or may acquire a security interest in such property which the creditor is unable to identify.

(6) A description of any penalty charges that may be imposed by the creditor or his assignee for prepayment of the principal of the obligation (such as a real estate mortgage) with an explanation of the method of computation of such penalty and conditions under which it may be imposed.

(7) Identification of the method of computing any unearned portion of the finance charge in the event of prepayment in full of the obligation which includes precomputed finance charges and a statement of the amount or method of computation of any charges that may be deducted from the amount of rebate of such unearned finance charge that will be credited to the obligation or refunded to the customer. In circumstances where there is no provision for the rebate of unearned finance charge upon prepayment in full, that fact must also be disclosed.

(8) Where the annual percentage rate disclosed is prospectively subject to increase, the following additional disclosures are required:

a. the fact that the annual percentage rate is subject to increase and the conditions under which such rate may increase including: (1) identification of the index, if any; and (2) any limitation upon such increase;

b. the manner in which any increase in the annual percentage rate may be effected;

c. if the obligation is repayable in substantially equal installments at substantially equal intervals and the increase could be effeted by an increase in the periodic payment amount, a statement of the estimated increase caused by a hypothetical immediate increase of one quarter of one percentage point, based upon the number of scheduled periodic payments and the original amount financed as disclosed at consummation; and

d. if the obligation is repayable in substantially equal installments at substantially equal intervals and the increase could be effected by an increase in the number of periodic payments, a statement of the estimated increase in the number of periodic payments caused by a hypothetical immediate increase of one quarter of one percentage point based upon the periodic payment amount and the original amount financed as disclosed at consummation.

Moreover, the required disclosures must be clear, conspicuous, and in some meaningful sequence; and records of the disclosures must be retained by the lender for two years from the date of consummation.

If the lender does not know the exact amount of one or more of the prescribed disclosures, he is obligated to estimate that amount on the basis of "best information." There is no obligation, however, to correct such estimates if they subsequently prove to be erroneous.

In addition to the disclosure and records retention provisions of the Act and accompanying Regulation Z, the Act creates a statutory right of recision which, while inapplicable to first lien residential mortgage lenders, is of significance to second and subsequent lien residential mortgage lenders. This occurs because the borrower's exercising such a right of recision frequently leaves the lender in the position of sub-optimal deployment of loanable funds.

The Act and accompanying Regulation Z have made a substantial contribution to consumer welfare by mandating the aforementioned disclosures and through a standardization of credit terms. They do, however, generate significant compliance responsibilities for the lender and illustrate redundancies in the federal regulatory scheme when viewed together with the disclosures mandated by RESPA.

EQUAL CREDIT OPPORTUNITY ACT

The Equal Credit Opportunity Act, as amended in 1976, is designed to eliminate credit discrimination on the basis of: sex, marital status, race, color, religion, national origin, age, the fact that all or a portion of the applicant's income derives from any public assistance program, and the applicant's good faith exercise of any right under the omnibus Consumer Credit Protection Act.

Both the Act and the rules promulgated thereunder are antidiscriminatory in purpose, and prescribe the types of conduct in which the lender may engage during the application for and evaluation of prospective loans. The Act, for example, delineates the circumstances under which the lender may require the signature of a spouse or consumer credit information on the spouse in determining the applicant's credit worthiness. The Act and rules also require that the lender compile, and retain for 25 months from the date of consummation or denial, information on the applicant's race and/or national origin, sex, marital status, and age. The extent of the data collection and retention responsibility varies among the different categories of institutional lenders.

The Act and accompanying rules establish procedural requirements pertaining to real estate mortgage applicants. Specifically, the prospective lender is required to:

(1) notify the applicant of action taken within thirty (30) days of receipt of the completed application and, where no action has been taken, that fact must be so stated;

(2) notify the applicant in writing of any adverse action taken on the application;

(3) notify the applicant of the principal reason for any adverse action or of the applicant's right to request a statement of reasons as to why such adverse action has been taken; and

(4) provide the applicant with the Equal Credit Opportunity Notice, other such notices as may be required by law, and supplemental information or material at the option of the lender when adverse action has been taken and notice sent to applicant.

The Act affects residential real estate settlement costs by virtue of the fact that compliance, training, and related record keeping costs are passed along to the purchaser/borrower in loan origination fees and related charges.

HOME MORTGAGE DISCLOSURE ACT OF 1975

The Home Mortgage Disclosure Act of 1975 mandates data compilation to facilitate the enforcement of Title VIII of the Civil Rights Act of 1968 and the Community Reinvestment Act. It requires that lenders making federally related mortgage loans compile, and make available for public inspection, data on the number and total dollar amount of mortgage loans made by Census tract or zip code category. The data must be broken down by number of loans and total dollar amount in each of the following categories:

- FHA and VA loans (with the exception of those on multi-family dwellings);

- other residential mortgage loans (including conventionals on other than multi-family dwellings);
- total FHA/VA, and conventional loans with the exception of those on multi-family dwellings;
- total home improvement loans on other than multi-family dwellings; and
- total mortgage loans on multi-family dwellings.

The lender must also provide a break for loans that are originated or purchased and secured by real property located in an SMSA where the lender has an office. The lender should maintain a record, by Census tract number, of the total amount of loans secured by residential property not intended to by occupied as a principal residence as of the time the loan is originated. The Act affects residential real estate settlement costs because lenders apportion costs of compliance over their loan portfolio, with such costs frequently being recouped in settlement charges assessed to the purchaser/borrower.

TITLE VIII OF THE CIVIL RIGHTS ACT OF 1968

Title VIII of the Civil Rights Act of 1968--popularly referred to as the Fair Housing Act of 1968, and significantly implemented by other legislation discussed here--prohibits in pertinent part discrimination in real estate lending on the basis of race, color, religion, sex, or national origin. The prohibition applies to loans for the purchase, construction, improvement, repair, or maintenance of a dwelling; it includes both an institution's willingness to make the loan and the terms of the loan, including--but not limited to--the amount of the loan, interest rate, and duration.

The importance of this legislation, together with some of the other equal opportunity legislation, is that it places significant pressure on the lender to formalize and review lending procedures. It also mandates, as a defense measure, the preparation, retention, and disclosure of documentary evidence of both fair dealing and service vis-a-vis the needs of the community as a whole.

COMMUNITY REINVESTMENT ACT OF 1977

The Community Reinvestment Act of 1977, regarded by many as an "antiredlining" statute, requires that the federal supervisory agencies encourage financial institutions to fulfill the credit needs of the local communities in which they are charted in a fashion "consistent with safe and sound operation of the institutions." The Act specifically requires that the federal financial supervisory agencies promulgate regulations to carry out the purposes of the

Act and that, in connection with the examination of financial institutions under their tutelage, such agencies:

(1) assess the institution's record of meeting the credit needs of the entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operation of such institution; and

(2) take such record into account in its evaluation of an application for a deposit facility (e.g., branch, etc.) by such institution.

The effect of the legislation on institutional lenders is most apparent in the Act's definition of application for a deposit facility; it includes application for:

(1) a charter for a national bank or federal savings and loan association;

(2) deposit insurance in connection with a newly chartered state bank, savings bank, savings and loan association, or similar institution;

(3) the establishment of a domestic branch or other facility with the ability to accept deposits of a regulated financial institution;

(4) the relocation of the home office or branch of a regulated financial institution;

(5) the merger or consolidation with, or the acquisition of the assets of, or other assumption of liabilities of a regulation financial institution requiring approval under section 18(c) of the Federal Deposit Insurance Act or under regulations issued under the authority of Title IV of the National Housing Act; or

(6) the acquisition of shares in, or the assets of, a regulated financial institution requiring approval under section 3 of the Bank Holding Company Act of 1956 or section 408(e) of the National Housing Act.

The implications of the Act for the institutional lender--although somewhat obscured by the "safe and sound operation" language of section 804(i)-- mandate a realignment of both credit rationing policies and portfolio, with the espoused goal of servicing the credit needs of the local community. The legacy of such a realignment should be increased costs for the lender and, ultimately, for the purchaser/borrower.

FAIR DEBT COLLECTION PRACTICES ACT

The Fair Debt Collection Practices Act, which has been incorporated into the omnibus Consumer Credit Protection Act as Title VIII, was enacted to eliminate abusive credit collection practices. It sets forth a series of procedural requirements dealing with:

- acquisition of information;
- communications connected with debt collection;
- harrassment or abuse;
- validation of debts;
- unfair collection practices; and
- false or misleading representations.

It renders the enforcement of such requirements the province of the federal financial supervisory agencies. It also states that violation of the requirements set forth under the Act shall be considered an unfair trade practice under section 5 of the Federal Trade Commission Act. This Act affects residential mortgage lenders in that it generates substantial compliance responsibilities in circumstances where collection responsibilities are borne by or attributable to the lender, and it entails both training and review costs to ensure compliance as an alternative to civil liability.

FEDERAL STATUTORY SUMMARY

The aforementioned acts and regulations are by no means intended as an exhaustive list of the federal regulations affecting real estate settlement costs. Numerous acts of subsantial import--such as the Securities Act of 1933, the Investment Company Act of 1940, and the Interstate Land Sales Act--have been omitted intentionally. The acts discussed here, however, are indicative of the lender's substantial compliance responsibilities and resultant costs. There seems to be a lack of integration and substantial duplication in the federal scheme of regulation.

APPENDIX E

MORTGAGE GUARANTY INSURANCE MODEL ACT

(2) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, providing the improvement on such real estate is a building or buildings designed for occupancy by five or more families or designed to be occupied for industrial or commercial purposes.

(3) Insurance against financial loss by reason of nonpayment of rent or other sums agreed to be paid under the terms of a written lease for the possession, use or occupancy of real estate, provided the improvement on such real estate is a building or buildings designed to be occupied for industrial or commercial purposes.

Section 1.11(b) Authorized Real Estate Security.

Authorized real estate security for the purpose of this chapter means an amortized note, bond or other evidence of indebtedness, not exceeding 95 percent of the fair market value of the real estate, secured by a mortgage, deed of trust, or other instrument which constitutes, or is equivalent to, a first lien or charge on real estate; provided:

(1) The real estate loan secured in such manner is one of a type which a bank, savings and loan association, or an insurance company, which is supervised and regulated by a department of this state or any agency of the federal government, is authorized to make, or would be authorized to make, disregarding any requirement applicable to such an institution that the amount of the loan not to exceed a certain percentage of the value of the real estate.

(2) The improvement on such real estate is a building or buildings designed for occupancy as specified by paragraphs 1.11(a)(1) and 1.11(a)(2) of this section.

(3) The lien on such real estate may be subject to and subordinate to the following:

(i) The lien of any public bond, assessment or tax, when no installment, call or payment of or under such bond, assessment or tax is delinquent.

(ii) Outstanding mineral, oil, water or timber rights, rights-of-way, easements or rights-of-way of support, sewer rights, building restrictions or other restrictions or covenants, conditions or regulations of use, or outstanding leases upon such real property under which rents or profits are reserved to the owner thereof.

Section 1.11(c) Contingency Reserve.

"Contingency reserve" means an additional premium reserve established to protect policyholders against the effect of adverse economic cycles.

ARTICLE 2. CAPITAL AND SURPLUS

Section 2.10 Capital and Surplus.

A mortgage guaranty insurance company shall not transact the business of mortgage guaranty insurance unless: if a stock insurance company, it has paid-in capital of at least one million dollars and paid-in surplus of at least one million dollars, or if a mutual insurance company, a minimum initial surplus of two million dollars. A stock company or a mutual company shall at all times thereafter maintain a minimum policyholders' surplus of at least one million five hundred thousand dollars.

ARTICLE 3. LIMITATIONS AND RESTRICTIONS FOR TRANSACTING BUSINESS

Section 3.10 Insurers Authority to Transact Business.

No mortgage guaranty insurance company may issue policies until it has obtained from the commissioner of insurance a certificate setting forth that fact and authorizing it to issue policies.

the terms of any note or bond or other evidence of indebtedness secured by a mortgage or deed of trust, such as requiring a stipulated down payment by the borrower.

(b) No mortgage guaranty insurance company may discriminate in the issuance or extension of mortgage guaranty insurance on the basis of the applicant's sex, marital status, race, color, creed or national origin.

(c) No policy or mortgage guaranty insurance excluding policies of reinsurance, shall be written unless and until the insurer shall have conducted a reasonable and thorough examination of (i) the evidence supporting credit worthiness of the borrower and (ii) the appraisal report reflecting market evaluation of the property and shall have determined that prudent underwriting standards have been met.

Section 3.17 Policy Forms and Premium Rates Filed.

(a) All policy forms and endorsements shall be filed with and be subject to the approval of the commissioner. With respect to owner-occupied, single-family dwellings, the mortgage guaranty insurance policy shall provide that the borrower shall not be liable to the insurance company for any deficiency arising from a foreclosure sale.

(b) In addition, each mortgage guaranty insurance company shall file with the department the rate to be charged and the premium including all modifications of rates and premiums to be paid by the policyholder.

(c) Every mortgage guaranty insurance company shall adopt, print and make available a schedule of premium charges for mortgage guaranty insurance policies. Premium charges made in conformity with the provisions of this chapter shall not be deemed to be interest or other charges under any other provision of law limiting interest or other charges in connection with mortgage loans. The schedule shall show the entire amount of premium charge for each type of mortgage guaranty insurance policy issued by the insurance company.

Section 3.18 Outstanding Total Liability.

A mortgage guaranty insurance company shall not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding 25 times its capital, surplus and contingency reserve. In the event that any mortgage guaranty insurance company has outstanding total liability exceeding 25 times its capital, surplus and contingency reserve, it shall cease transacting new mortgage guaranty business until such time as its total liability no longer exceeds 25 times its capital, surplus and contingency reserve.

ARTICLE 4. REBATES, COMMISSIONS, CHARGES AND CONFLICT OF INTEREST

Section 4.10 Rebates, Commissions and Charges.

(a) A mortgage guaranty insurance company shall not pay or cause to be paid either directly or indirectly, to any owner, purchaser, lessor, lessee, mortgagee or prospective mortgagee of the real property which secures the authorized real estate security or which is the fee of an insured lease, or any interest therein, or any person who is acting as an agent, representative, attorney or employee of such owner, purchaser or mortgagee, any commission, or any part of its premium charges or any other consideration as an inducement for or as compensation on any mortgage guaranty insurance business.

(b) In connection with the placement of any mortgage guaranty insurance, a mortgage guaranty insurance company shall not cause or permit any commission, fee, remuneration, or other compensation to be paid to, or received by any insured lendor or lessor; any subsidiary or affiliate of any insured; and officer, director, or employee of any insured or any member of their immediate family; and corporation, partnership, trust, trade association in which any insured is a member, or other entity in which any insured or any such officer, director, or employee or any member of their immediate family has a financial interest; or any designee, trustee, nominee, or other agent or representative of any of the foregoing.

4. Insured leases in default for four months or for any lesser period which is defined as default for such purposes in policy provisions.

Section 5.12 Contingency Reserve.

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of reinsurance) after establishment of the unearned premium reserve. The mortgage guaranty insurance company shall contribute to the contingency reserve an amount equal to 50% of such remaining unearned premiums. Contributions to the contingency reserve made during each calendar year shall be maintained for a period of one hundred and twenty months, except that withdrawals may be made by the company in any year in which the actual incurred losses exceed 35% of the corresponding earned premiums, and no such releases shall be made without prior approval by the commissioner of the insurance company's state of domicile.

If the coverage provided in this act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.

Section 5.13 Reinsurance.

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company which is properly licensed to provide such reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this chapter in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this chapter.

Section 5.14 Miscellaneous.

(a) Whenever the laws of any other jurisdiction, in which a mortgage guaranty insurance company subject to the requirement of this act, is also licensed to transact mortgage guaranty insurance, require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of such larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this chapter.

(b) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this chapter as required by Sections 5.10 and 5.12. Unearned premium reserves and contingency reserves on risks insured before the effective date of this chapter may be computed and maintained as required previously.

ARTICLE 6. REGULATIONS

Section 6.10 Regulations.

The commissioner shall have authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this chapter.

Legislative History (all references are to the Proceedings of the NAIC).

1976 Proc. II 747-753

APPENDIX F

1978 NATIONAL CORPORATE AFFILIATIONS, MARKET SHARES, AND STATES OF OPERATION

PARENT CORPORATION SUBSIDIARY TITLE INSURANCE COMPANY (TIC)	1978 DIRECT PREMIUMS ($000,000)	NATIONAL MARKET SHARE	NATIONAL MARKET SHARE RANK	STATES OF OPERATION
Santa Fe Industries, Inc.	199.439	19.57	1	All States Except IA, ND
Pioneer National TIC (CA)	104.046			All States Except AK,HI,IA,ND, also sold in GU, PR, VI, CN
TI Dept.Of TI & Trust C.(CA)	78.778			CA, HI, NV
The TGC (NY)	12.652			NY
Alaska TGC	3.232			AK
Northern Counties TIC (CA) (50% Ownership with the Morton Family)	.735			CA
Lincoln National Corp.	140.184	13.75	2	All States & PR, VI, CN, Bahamas.
Chicago TIC of KS City	138.751			All States & PR, VI, CN, Bahamas.
McHenry County TIC	1.433			IL
SAFECO Corp.	110.727	10.86	3	All States Except CT, IA, KS, ME, MA, NY, ND, WI, WY, Some in PR, VI
SAFECO TIC	96.021			AK, AZ, CA, CO, FL, GA, HI, IL IN, KY, LA, MI, MO, NV. NM, OH, TN, TX, UT, WA
The TGC (Baltimore, MD)	7.043			AL, AR, DE, DC, FL, GA, IN, KY, LA, MD, MS. NM, NC, OH, PA, RI, SC, TN, TX, UT, VA, WV, PR, VI
SAFECO TIC Of ID	2.083			ID, MT, SD
SAFECO TIC Of OR	5.556			OR
Security TIC (CA)	.024			CA
First American Financial Corporation	84.764	8.32	4	All States Except AK, IL, IN, IA, KS, KY, ME, MA, MI, MN, NV, ND, OH, RI, TN, VT, WV, WI
First American TIC of Santa Ana, CA	61.701			AL, AR, CA, CO, CT, DE, DC, FL GA, HI, ID, LA, MD, MS, MO, MT, NE, NV, NJ, NM, NC, OK, PA, SC, SD, TX, UT, VA, WA, WY, GU
First American Title Guaranty Co	*			
AZ TI & Trust Co.	8.597			AZ
First American TIC of OR	8.111			OR
First American TIC of NY	4.347			NH, NY
Security Title & Trust Co. (San Antonio, TX)	.971			WY
The TGC of WY, Inc. (WY)	1.037			TX
Security Title Guaranty Co.	*			*
Standard TIC	*			*
Transamerica Corp. (CA)	71.772	7.04	5	AK, AZ, CA, CO, MI, NM OR, TX, UT, WA
Transamerica TIC (CA)				
Reliance Group, Inc.	71.180	6.98	6	All States Except AK, also sold in CN, Bahamas, GU, PR, VI
Commonwealth Land TIC (PA)	70.630			All States Except AK, also sold in CN, Bahamas, GU, PR, VI
TIC (Mobile, AL)	.559			AL, MS
The Continental Group, Inc.	63.218	6.20	7	All States Except WA
Lawyers TIC	59.350			All States except WA, also sold in PR, VI, CN, and Bahamas
Mid-South TIC (Commerce TGC)	2.641			AL, AR, FL, LA, MS, TN
Land TIC (CA)	1.227			CA
The Title Guaranty & Trust Co.	*			*

* Information not available or not exact.

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APPENDIX F (Continued)

PARENT CORPORATION SUBSIDIARY TITLE INSURANCE COMPANY (TIC)	1978 DIRECT PREMIUMS ($000,000)	NATIONAL MARKET SHARE	NATIONAL MARKET SHARE RANK	STATES OF OPERATION
Old Republic International Corporation	56.938	5,59	8	All states except DC, ID, IA, ME, MD, NH, NY, OR, VT, WA
TIC of MN	52.825			All States Except DC, ID, IA, ME, MD, NH, NY, OR, VT, WA,
MS Valley TIC	4.113			AL, AR, FL, GA, MS, TN
Stewart Information Services Corp.	42.630	4.18	9	All States Except AK, CT, ID, IA, KS, ME, MA, MN, MO, MT, NE, NH, NY, ND, OR, RI, SD VT, WA, WV, WY.
Stewart TGC (TX)				
USLIFE Corp.	37.978	3.73	10	All States Except AK, HI, IN, IA, KS, MN, MT, NE, NV, ND, OR, SD, WA, WY
USLIFE TIC of Dallas	26.377			AL, AZ, AR, CA, CO, GA, LA, MS, MO, NM, OK, TX, UT,
USLIFE TIC of NY	11.601			CT, DE, DC, FL, IL, ID, KY, ME, MD, MA, MI, NH, NJ, NY, NC, OH, PA, RI, SC, TN, VT, VA, WV, WI
The St. Paul Companies, Inc.	28.594	2.81	11	All States & PR Except AK, CT, DC, HI, ID, IA, ME, MA, NH, NY, ND, OR, RI, SD, VT, WA, WY
St. Paul TIC (MO)	15.641			All States & PR Except AK, CO, CT, DC, HI, ID, IA, ME, MA, MT, NH, NY, ND, OH, OR, RI, SD, VT, WA, WY
Burton Abstract and TC	10.697			MI
St. Paul TIC of the South	2.256			AR, GA, LA, MS, NM,NC, OH OK, SC, TX
The Continental Corporation	24.395	2.39	12	All States & PR, VI (Small Amts. in Bahamas, Neth. Antilles & Cayman Islands) Except AK,ID, IA, MT, ND, OR, SD, WA
American TIC	19.766			All States & PR, VI, Neth. Antilles Except AK, ID, IA, MT, ND, OR, SD, WA
TI Corp. of PA	2.986			CT, DE, LA, MD, MA, NH, NJ NC, OH, PA, RI, SC, TN, UT, VT, VA, PR, VI, Bahamas, Neth. Antilles
Columbia Real Estate TIC	1.404			DC, MD, OH, VA
TX TGC, Inc. (Dallas)	3.225			TX
The Morton Family (also owns 50% of Northern Counties TIC with Santa Fe Industries, Inc.)				
Western TIC	17.481	1.72	13	CA
Industrial Valley Bank & Trust Co.	8.214	.81	14	DE, DC, FL, HI, MA,MD, NJ, OH, PA, SC, VA
District-Realty TIC	3.620			DE, DC, MD, VA
Industrial Valley TIC	3.018			DE, FL, MA, OH, PA, SC
Continental TIC (West Jersey T & G. Co.)	1.576			DE, HI, NJ, PA, SC
Chelsea TIC	7.674	.75	15	AR, CT, FL, LA, MD, NH, NJ, OH, PA, WV, VI

APPENDIX F (Continued)

PARENT CORPORATION SUBSIDIARY TITLE INSURANCE COMPANY (TIC)	1978 DIRECT PREMIUMS ($000,000)	NATIONAL MARKET SHARE	NATIONAL MARKET SHARE RANK	STATES OF OPERATION
BAR-RELATED TITLE INSURANCE COMPANIES				
Attorneys' TG Fund, Inc. (CO)	.433	.04		CO, UT, MN
Attorneys' TG Fund, Inc. (GA)	.210*	.02		GA
Attorneys' TG Fund, Inc. (IL)	1.168*	.11		IL
Connecticut Attorneys' TG Fund, Inc.	1.040*	.10		CT
Insured Titles, Inc. (KS)	.841	.08		AR, KS, LS, MO, MT, NE, ND, OK, WI
Lawyers' TG Fund of Orlando, FL	6.536	.64	16	FL, NY, ME, NJ, PA, CT, VI
Lawyers' TG Fund (FL)	6.231			FL
**City TIC (NY) (60% Owned)	.305			CT, FL, ME, NJ, NY, PA, VI
Maine Bar Association Mutual TIC	*	*		ME
National Attorneys' Title Assurance Fund, Inc. (IN)	.087*	.01		IN
** The Ohio Bar TIC	1.591[1]	.16		OH
	TOTAL $1,019,216 million	100.00%		
	4-Firm Concentration Ratio	= 52.50%		

1 Title insurance premiums earned.

2 No figure is kept by firm.

* Information not available or not exact.

APPENDIX G

TITLE INSURANCE FIRMS, WITH PREMIUMS WRITTEN, MARKET SHARE, AND FIRM'S STATE RANK

CALIFORNIA 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
Santa Fe Industries, Inc.	74,823,159	23.15	1
T.I. Dept. Of T.I. And Trust Co.	73,568,850		
Pioneer National TIC	518,870		
Northern Counties TIC (50% owned by the Morton Family)	735,439		
SAFECO Corp.	62,959,996	19.48	2
SAFECO TIC	62,935,932		
Security TIC (CA)	24,064		
First Am. TIC	32,920,689	10.19	3
Transamerica	25,489,438	7.89	4
Western (Owned by Morton Family)	17,481,422	5.41	5
Chicago TIC	14,973,591	4.63	6
National American	4,230,000	1.31	7
TIC Of MN.	3,334,453	1.03	8
Commonwealth Land	2,898,362	.90	9
The Continental Group, Inc.	2,618,422	.81	10
Lawyer's TIC	1,391,250		
Land TIC	1,227,172		
Stewart TGC	1,588,432	.49	11
St. Paul	1,324,099	.41	12
American	657,757	.20	13
USLIFE Of Dallas	439,221	.14	14
Total	245,739,041		
4 Firm Concentration Ratio		60.71%	

COLORADO 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
Transamerica	12,498,766	50.24	1
Chicago	2,214,245	8.9	2
Pioneer National	2,146,712	8.63	3
Fidelity National	1,663,686	6.69	4
First American	1,251,130	5.03	5
US LIFE Of Dallas	1,236,897	4.97	6
Stewart TGC	1,031,387	4.15	7
Commonwealth Land	1,001,867	4.03	8
Lawyer's TIC	939,542	3.78	9
TIC Of MN.	456,254	1.83	10
SAFECO	397,756	1.56	11
American TIC	42,105	.17	*
St. Paul	*	*	*
Attorney's TG Fund	210,448	*	
Total	25,090,795		
4 Firm Concentration Ratio		74.46%	

SOURCE: Compiled by Peat, Marwick, Mitchell & Co. from annual statutory statement (Form-9's) filed by Title Insurance Companies with State Insurance Commissions

* Information not available or not exact.

APPENDIX G (Continued)

VIRGINIA 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
Lawyer's TIC	$6,005,687	33.63	1
Pioneer National TIC	2,670,432	14.95	2
Commonwealth Land TIC	2,173,957	12.17	3
Chicago TIC	1,924,759	10.78	4
First American TIC	1,428,259	8.00	5
The Continental Corporation	883,414	4.95	6
Columbia Real Estate TIC	683,114		
American TIC	199,606		
TICorp. of PA	694		
Southern TICorp. of Richmond, VA	570,175	3.19	7
Berks TIC	557,755	3.12	8
USLIFE TIC of NY	470,931	2.64	9
Title Guaranty Co. of Balto., MD	351,776	1.97	10
District-Realty TIC	283,444	1.59	11
Jefferson-Pilot TIC	180,415	1.01	12
St. Paul TIC	136,584	.76	13
Stewart TGC	123,262	.69	14
Security TG Corp. of Balt., MD	80,238	.45	15
Southern TIC of Knoxville, TN	17,897	.10	16
Security TGC of NY	126	.00	17
Total	$17,859,111		
4-Firm Concentration Ratio	14	71.53%	

MARYLAND 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
Title Guaranty Co. of Balto., MD	$3,666,759	22.85	1
District-Realty TIC	2,145,997	13.37	2
Commonwealth Land TIC	2,026,294	12.63	3
Pioneer National TIC	1,738,092	10.83	4
Security Title Guaranty of Balto., MD	1,399,400	8.72	5
Lawyer's TIC	1,192,564	7.43	6
Chicago TIC	1,160,526	7.23	7
USLIFE TIC of NY	838,990	5.23	8
Chelsea TIC	473,144	2.95	9
First American TIC	449,610	2.80	10
Berks TIC	366,996	2.29	11
The Continental Corporation	247,444	1.54	12
Columbia Real Estate TIC	210,766		
TI Corp. of PA	35,053		
American TIC	1,625		
Stewart TGC	215,164	1.34	13
St. Paul TIC	127,363	.79	14
Security Title Guaranty Co. of NY	1,159	.01	15
Total	$16,049,502		
4 Firm Concentration Ratio		59.68%	

APPENDIX G (Continued)

WASHINGTON, D.C. 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
District-Realty TIC	1,164,666	31.06	1
Commonwealth Land TIC	884,202	24.58	2
Chicago TIC	526,515	14.04	3
Lawyer's TIC	340,274	9.08	4
The Continental Corporation	338,261	9.02	5
Columbia Real Estate TIC	332,836		
American TIC	5,425		
First American TIC	148,540	3.96	6
Pioneer National TIC	124,484	3.32	7
Stewart TGC	95,958	2.56	8
USLIFE TIC of NY	64,475	1.72	9
Berks TIC	57,182	1.53	10
The Title Guaranty Co. (Balto.) (SAFECO)	2,405	.06	11
Security Title Guaranty Corp. Of Balt.,	2,031	.05	12
Security Title & Guaranty Co. (NY)	237	.01	13
Total	3,749,230		
4 Firm Concentration Ratio		78.76%	

FLORIDA 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
· Chicago TIC	7,181,598	14.64	1
· The Continental Group, Inc.	6,668,595	13.59	2
Lawyer's TIC	6,102,184		
Mid-South TIC (Commerce TGC)	566,411		
· Lawyer's TG Fund Plus City TIC	6,232,387	12.70	3
Lawyer's TG Fund Inc. (FL)	6,230,873		
City TIC	1,514		
· American TIC	4,552,412	9.28	4
· Pioneer National TIC	4,032,746	8.22	5
· T & Trust Co. Of FL	3,257,851	6.64	6
· Chelsea T & Guaranty Co.	2,976,335	6.07	7
· Commonwealth Land	2,529,377	5.16	8
· Stewart TGC	2,135,633	4.35	9
· Old Republic International Corp.	2,108,472	4.30	10
TIC of MN	2,092,123		
Mississippi Valley TIC	16,349		
· SAFECO	1,932,613	3.94	11
SAFECO TIC	1,610,881		
The Title Guaranty Company (Baltimore)	321,732		
· First Am.	1,445,829	2.95	12
· US LIFE TIC Of NY	1,403,453	2.86	13
· St. Paul TIC (MN)	1,183,411	2.41	14
· Southeast Title Insurance Co. Of FL	609,915	1.24	15
· Industrial Valley TIC	413,558	.84	16
· National TIC	100,611	.21	17
· Southern TIC (TN)	96,877	.20	18
· Southeast Title Insurance Company	82,357	.17	19
· Security T. & Guaranty Co. (NY)	74,181	.15	20
· Berks TIC	42,000	.09	21
· Security Title Guaranty Corp. Of Balto.	1,845	.00	22
Total	49,062,056		
4 Firm Concentration Ratio		50.21	

APPENDIX G (Continued)

MASSACHUSETTS 1978

FIRM	WRITTEN DIRECT PREMIUMS	MARKET SHARE (%)	STATE RANK
Lawyer's TIC	696,780	33.28	1
Chicago TIC	425,264	20.49	2
Pioneer National	386,758	18.63	3
The Continental Corporation	322,973	15.56	4
American TIC	307,248		
The T.I. Corp. Of PA	15,725		
US LIFE TIC Of NY	108,360	5.22	5
Commonwealth Land	99,430	4.79	6
Security T & G Co. (NY)	21,235	1.02	7
TIC Of MN.	15,233	.73	8
Industrial Valley TIC	5,568	.27	9
Massachusetts TIC	*	*	*
Total	2,075,601		
4 Firm Concentration Ratio		87.96%	

MISSOURI 1978

FIRM	WRITTEN DIRECT PREMIUMS	MARKET SHARE (%)	STATE RANK
Chicago TIC	3,277,587	24.02	1
St. Paul	2,405,715	17.63	2
Pioneer National	2,348,675	17.21	3
TIC Of MN	1,734,689	12.71	4
Lawyer's TIC	1,643,287	12.04	5
Commonwealth Land	1,153,626	8.46	6
USLIFE (Dallas)	912,810	6.69	7
SAFECO	437,097	3.20	8
First American	252,852	1.85	9
Insured Titles, Inc.	231,408*	1.70	10
American	67,890	.50	11
Total	13,644,107		
4 Firm Concentration Ratio		71.57%	

* Information not available or not exact.

APPENDIX G (Continued)

TEXAS 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
Stewart TGC	32,891,986	21.64	1
TIC Of MN.	26,934,336	17.72	2
US LIFE TIC Of Dallas	19,042,766	12.53	3
Pioneer National TIC	15,556,829	10.24	4
Chicago TIC	14,661,494	9.65	5
Commonwealth Land	10,077,190	6.63	6
First Financial Corp.	10,037,362	6.60	7
First American TIC	9,000,249		
Security T&Trust Co. (San Antonio)	1,037,113		
Transamerica	4,497,758	2.96	8
SAFECO	4,308,834	2.83	9
SAFECO TIC	3,692,892		
The Title Guaranty Co. (Baltimore)	615,942		
The Continental Corporation	3,869,405	2.55	10
TX TGC, Inc. (Dallas)	3,224,541		
American	644,864		
Lawyer's TIC	3,733,431	2.46	11
Alamo	3,101,527	2.04	12
The St. Paul Companies, Inc.	1,719,798	1.13	13
St. Paul TIC Of The South	1,530,843		
St. Paul TIC	188,955		
Southern TGC, Inc. (Houston, TX) (Owned by Insurance Company of North America)	1,562,779	1.03	14
Total	151,995,495		
4 Firm Concentration Ratio		62.13	

WASHINGTON 1978

FIRM	DIRECT PREMIUMS WRITTEN	MARKET SHARE (%)	STATE RANK
Pioneer National TIC	16,660,565	32.65	1
SAFECO	15,345,558	30.07	2
Transamerica	11,973,643	23.47	3
First American	3,677,839	7.21	4
Chicago TIC	3,192,558	6.26	5
Mason County TIC (Shelton, WA)	173,000	.34	6
Commonwealth Land	4,444	.01	7
Total	51,027,607		
4 Firm Concentration Ratio		93.40	

APPENDIX H

DISTRIBUTION OF CALCULATED COMMISSION RATES

DISTRIBUTION OF CALCULATED COMMISSION RATES FOR PRICE RANGE $35,000–$40,000

City	N	(%)	Less Than 5%	At 5%	5% - 6%	At 6%	6% - 7%	At 7%	Greater Than 7%
Boston	12		2 (16.7)	-	-	5 (41.7)		5 (41.7)	-
Denver	11		2 (18.2)	1 (9.1)	1 (1.5)	1 (1.5)	-	6 (54.5)	-
Washington, D.C.	0		-	-	-	-		-	-
Jacksonville	58		12 (20.7)	11 (19.0)	4 (6.9)	8 (13.8)	9 (15.5)	9 (15.5)	5 (8.6)
Los Angeles	2		-	-	-	2 (100.0)	-	-	-
St. Louis	21		2 (9.5)	-	-	19 (90.5)	-	-	-
San Antonio	8		3 (37.5)	1 (12.5)	-	4 (50.0)	-	-	-
Seattle	50		11 (22.0)	3 (6.0)	5 (10.0)	13 (26.0)	-	16 (32.0)	2 (4.0)

DISTRIBUTION OF CALCULATED COMMISSION RATES FOR PRICE RANGE $55,000–$60,000

City	N	(%)	Less Than 5%	At 5%	5% 6%	At 6%	6% - 7%	At 7%	Greater Than 7%
Boston	8		-	1 (12.5)	2 (25.0)	4 (50.0)	-	1 (12.5)	-
Denver	14		1 (7.1)	-	-	6 (42.9)	-	4 (28.6)	2 (14.3)
Washington, D.C.	8		4 (50.0)	-	-	4 (50.0)	-	-	-
Jacksonville	8		4 (50.0)	-	1 (12.5)	1 (12.5)	1 (12.5)	1 (12.5)	-
Los Angeles	8		2 (25.0)	1 (12.5)	-	4 (50.0)	-	-	1 (12.5)
St Louis	13		-	1 (7.7)	2 (15.4)	10 (76.9)	-	-	-
San Antonio	8		3 (14.3)	-	-	5 (62.5)	-	-	-
Seattle	52		1 (1.9)	5 (9.6)	6 (11.5)	18 (34.6)	-	17 (32.7)	5 (9.6)

DISTRUBUTION OF CALCULATED COMMISSION RATES FOR PRICE RANGE $75,000–$80,000

CITY	N (%)	LESS THAN 5%	AT 5%	5%-6%	AT 6%	6%-7%	AT 7%	GREATER THAN 7%
BOSTON	6	-	1 (16.7)	2 (33.3)	3 (50.0)	-	-	-
DENVER	4	-	-	-	2 (50.0)	-	2 (50.0)	-
WASHINGTON, D.C.	3	1 (33.3)	-	-	2 (66.7)	-	-	-
JACKSONVILLE	4	1 (25.0)	-	-	2 (50.0)	1 (25.0)	-	-
LOS ANGELES	10	4 (40.0)	-	1 (10.0)	5 (50.0)	-	-	-
ST. LOUIS	7	-	-	-	7(100.0)	-	-	-
SAN ANTONIO	9	1 (11.1)	-	-	7 (77.8)	-	1 (11.1)	-
SEATTLE	26	1 (3.8)	4 (15.4)	2 (7.7)	9 (34.6)	-	8 (30.8)	2 (7.7)

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